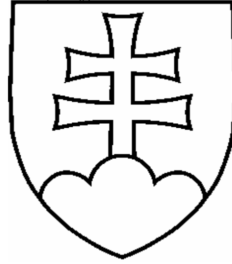


Ministry of Finance
of the Slovak Republic

UPDATED CONVERGENCE PROGRAMME FOR THE SLOVAK REPUBLIC

covering the period 2004-2010

November 2004

CONTENT

CONTENT 2
INTRODUCTION 3
I. OVERALL POLICY FRAMEWORK AND OBJECTIVES 4
I.1. Economic Policy Objectives until 2010 4
I.2 Fiscal policy 4
I.3. Monetary and Exchange Rate Policy 5
I.4 Structural Policies 5
II. ECONOMIC OUTLOOK 7
II. 1. Current Development Trends 7
II.2. The Present and Anticipated Development of External Conditions 8
II.3. Forecasted Development of the Real Economy and of the Labour Market 9
II.4 Cyclical Position 10
II.5 Expectations in the Monetary Area 11
II.6 External Sector Outlook 13
II.7. Risks of the Forecasts and Alternative Scenarios 14
III. GENERAL GOVERNMENT BALANCE AND DEBT 16
III.1 Medium-Term Fiscal Framework 16
III.2. General Government Revenues 19
Tax revenues 19
Social security contributions 19
Non-tax revenues 20
Grants and transfers 21
III.3 General Government Expenditures 21
Current expenditures 21
Capital expenditures 22
III.4 Cyclically Adjusted Balance 24
III.5 Fiscal Impulse 24
III.6. Public Debt and Risks 26
IV. STRUCTURAL POLICY AND ITS IMPACT ON PUBLIC FINANCES 28
IV.1 Health Care 28
IV.2 Fiscal Decentralisation 30
IV.3. Act on Budgetary Rules 32
V. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES 33
V.1. Demography 33
V.2. Results 35
VI. COMPARISON WITH MAY 2004 CONVERGENCE PROGRAMME 36
ANNEXES 37

INTRODUCTION

May 1st, 2004 is a historic milestone for the Slovak Republic. Accession to the European Union sets a basis for increased prosperity on both sides. On the one hand, active participation in the European economic processes, along with fair competition and liberalisation, will increase the quality of life in Slovakia. On the other hand, participation in the shaping of the EU economic policy will enable Slovakia to contribute towards enhancing the efficiency of the processes aimed meeting the ambitious goals set out in the Lisbon Strategy.

Upon accession, the country automatically becomes a part of the Economic and Monetary Union (EMU) and thereby assumes certain obligations, one of them being the obligation to prepare, as of 1st December each year, stability programmes for the euro-zone members, and convergence programmes (CP) for other EU Member States. These programmes should focus mainly on expected fiscal developments. Slovakia presented its first Convergence Programme out of the regular cycle, upon its accession to the European Union. **Since the update of the programme was prepared only several months after its initial submission, the trends described in the May version reflect, in all material respects, both the macroeconomic and fiscal development**. This is one of the reasons why the scope of the update is much narrower than in the case of the first Convergence Programme.

With the public finance deficit exceeding 3% of GDP, Slovakia received recommendations on how to bring it down as quickly and efficiently as possible. The government-approved multi-annual budget for 2005-2007, plus the effective launch of the health care reform, are in line with those recommendations. According to the latest estimates, despite the higher-than-expected economic growth public finance revenues at the year-end will be close to the level projected in the May version of the Convergence Programme. This means that the recommendation to apply additional revenues towards deficit reduction will be relevant only in the next period.

The CP has been prepared on the basis of the following documents:

- Programme Declaration of the Government
- Pre-accession Economic Programme for the Year 2003
- The Cardiff Report for the Years 2003 and 2004
- Specification of Strategy for the Adoption of Euro in the Slovak Republic
- The 2004 State Budget Act
- Draft of the 2005-2007 General Government Budget Act.

The most recent prognoses contained in this document were prepared as of 29 October 2004.

The first part of the CP sets out the main goals of the economic policy until 2010, followed by a section containing economic prognoses and assumptions. Parts Three to Five deal mostly with public finances: medium-term development, the impact of structural reforms upon public finances, and their long-term sustainability. Part Six compares the prognoses with the May version of CP. Indicative prognoses until 2010 and other tables and charts are presented in the annex.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

I.1. Economic Policy Objectives until 2010

The main objective of the economic policy is to *attain a strong and sustainable economic growth* and, thereby, elevate the living standard in Slovakia. This simple formulation encapsulates a broad array of policies and the need for their efficient coordination. This includes, in particular:

- *Fiscal policy* - which is based on three principles: transparency, responsibility and efficiency. The main objectives of the fiscal policy are: to reduce the deficit of public finances by 2006 below 3% of GDP (excluding the cost of implementing the second pillar of the pension system) and to achieve long-term sustainability of public finances by the year 2010. The long-term objective requires a strict adherence to the Stability and Growth Pact (having the deficit just under 3% of GDP is not enough), which, in real terms means, that Slovakia should have its system of public finances close to balance by the end of the decade.

- *Monetary and exchange rate policy* – the key objective here is price stability. Slovakia is small and very open economy and therefore exchange rate represents an important transmission channel of the monetary policy. That is the reason why monetary policy decisions of the central bank also depend on the departures of the exchange rate from its equilibrium level. The size and the degree of openness of the economy are the main factors behind Slovakia's ambition to enter the euro-zone in 2009. Economic policy makers believe that this step will also accelerate the real convergence of Slovakia.

- *The policies on the labour market, markets of products and services, and on financial markets* – the main objective in the area of employment is to bring the registered structural unemployment rate under 10% by the year 2010. The key objective on the market of products and services is to increase productivity through appropriate investment climate, higher intensity of competition, liberalisation, support to entrepreneurship and efficient regulation. The primary objective on the financial market is to maintain healthy competition and put in place an efficient financial framework. Slovakia avows the Lisbon Strategy and its economic policy will be geared towards meeting the goals set in the agenda. The Lisbon Strategy for Slovakia, which is currently under preparation, will focus on four areas: business environment, information society, innovation policy and human capital.

I.2 Fiscal policy

In 2002, the Slovak government set itself an ambitious goal: to reduce the deficit of public finances below 3% of GDP by the year 2006 (excluding the cost of implementing the second pillar of the pension system reform[1]). This goal is ambitious even more so that the consolidation takes place simultaneously with the reduction of the tax burden. One of the examples is the adoption of a fundamental tax and social insurance reform. The above-mentioned goal can only be achieved through profound structural reforms on the

[1] Given the fact that the introduction of the second pillar purely converts a portion of the implicit debt to the explicit one and, as such, does not increase demand, Slovakia will request that this fact be taken into consideration when evaluating compliance with the Maastricht criteria.

expenditure side of the budget, which will significantly reduce the degree of redistribution in the economy.

The goal is to achieve long-term sustainability of public finances by the year 2010. In other words, safe adherence to the Stability and Growth Pact in the long run, when the effects of population ageing will be culminating. This approach implicitly assumes that public finances in Slovakia should be brought close to balance no later than by the year 2010.

In general terms, fiscal policy should also support monetary policy. The consolidation of public finances has, of course, priority, which may narrow the room for automatic stabilisation at this stage. Nonetheless, the economic policy objectives should also include measures aimed at enhancing the effectiveness of stabilisers in the future. Their flexibility should increase, for example, through the approved adoption of appropriate labour market measures.

I.3. Monetary and Exchange Rate Policy

According to the NBS Act, the main goal of the National Bank of Slovakia (NBS) is to maintain price stability.

In practice, the implementation of monetary policy is oriented towards meeting the price stability goal; monetary policy reacts to the risk of deviation from the expected inflation set out in the NBS Monetary Programme.

Since Slovakia is a small and open economy (export of goods and services accounts for more than 150% of GDP), monetary policy considerations are also influenced by the development of the exchange rate, which has an important position in the monetary policy's transmission mechanism. The exchange-rate policy is implemented in the regime of managed floating.

In July 2003 the government approved the "Euro Adoption Strategy in the Slovak Republic". The document concludes that the advantages of membership in the eurozone will outweight its disadvantages and that the euro adoption will provide a strong additional stimulus to a sound growth of the Slovak economy.

In September 2004 the government passed the "Specification of Strategy for the Adoption of Euro in the Slovak Republic ". The main objective of this document was to offer detailed describtion of the accession process to the public and to specify the exact timetable based on the assessment of Maastricht criteria fulfillment on a sustainable basis. The main conclusion is that Slovakia will be ready to join the eurozone in 2009.

As regards the exchange-rate regime, the managed floating will be replaced, in the medium term, with the ERM II exchange rate mechanism. Slovakia is likely to enter ERM II no later than in the first half of 2006.

I.4 Structural Policies

- Labour market – flexible Labour Code (enacted in 2003) should, together with the expected rise in demand for labour (also in conjunction with the adopted safety net measures and system of social insurance), facilitate the meeting of the main goal – to bring the

registered structural unemployment rate under 10% by 2010. This goal implies a significant shift in focus towards the goals set in the Lisbon Strategy. The key factor in this respect is the rise in the demand for labour resulting from improved business environment. The success in attracting significant foreign direct investments is the first sign of positive development.

- Products market and capital market – This area is described in detail in the Cardiff Report which Slovakia submitted to the European Commission in October this year. The key objective on the product and services market is to increase productivity through appropriate investment climate, a higher intensity of competition, liberalisation, support to entrepreneurship and efficient regulation. The strengthening of the position of small and medium enterprises (SME) is also one of the key priorities of the economic policy. The primary objective for financial markets is to facilitate their further development and growth based on healthy competition and an efficient regulatory framework.

Slovakia avows the main goals of the Lisbon Strategy (higher employment and productivity) and its economic policy will be geared towards meeting the goals set in the agenda to incerase competitiveness. With all the important structural reforms completed and public finances consolidated, the focus of economic policy will shift towards developing the knowledge based economy and human capital. Research and development must, in the long run, play an important role in shaping up the national economic strategy.

- Environment – also described in the Cardiff Report. Sustainable development is the key objective.

II. ECONOMIC OUTLOOK

II. 1. Current Development Trends

Preliminary figures from the quarterly national accounts as well as economic and financial indicators monitored on a monthly basis up to October 2004 confirm the main development trends and expectations, showing a continued positive trend in the Slovak economy, as presented in Slovakia's 2004-2010 Convergence Programme. Also, development drivers within individual economic sectors operate as anticipated. As a result, the focus has shifted to only a handful of aspects in current economic development which either drive the 2004 forecasts or bear particular relevance to the monitoring of sustainable growth in the economy.

During the first half year in 2004, the growth of the Slovak economy outpaced initial expectations, going from 4.2% in 2003 all the way to 5.4%. So far, this brisker growth carried no risk to the continuing stable development of the economy. Inflation has been subsiding, with upside pressure stemming mainly from major adjustments in regulated prices and indirect taxes implemented earlier this year. The current account deficit is below the 3% of GDP, safely financed by foreign direct investments. The trend in the general government deficit has also remained on track with fiscal intentions, which creates good conditions for the implementation of the monetary policy in accordance with the NBS Monetary Programme. The trend in economic fundamentals, political stability as well as interventions by the NBS earlier this year helped underpin exchange rate stability, although slight upward pressures on the Slovak koruna vs the Euro still persist.

The growing performance of the economy is the result of growing labour productivity, which moved above the 5.5% mark in the first two quarters. On the other hand, employment was weaker than expected (down 0.5% over the first six months).

In contrast to 2003, GDP is not only pulled by foreign demand but also by a slight acceleration in domestic consumption and by a pick-up in investment.

The stronger-than-expected private consumption mainly resulted from a more robust growth in the disposable income of households and also from a decline in the savings rate. The current income of households grew stronger mainly as a result of the average nominal wage getting ahead of projections (10.3% increase in nominal and 1.9% in real terms) and a more favourable trend in inflation. On the other hand, current expenditures grew in nominal terms by no more than 1.5%, mainly as a result of lower direct taxes. However, employment fell shy of expectations, failing to bring about a rise in private consumption and to contribute to the downward trend in unemployment. Throughout the year, government consumption has been fluctuating, however the trend has been, by and large, consistent with fiscal intentions. The pick-up in investment comes after a time lag; however, the right kind of environment was put in place to encourage further development – low interest rates and the interest of foreign investors; an increase in inventory stocks is a specific signal that there is growth in investment and the economy. As originally anticipated, exports of goods have been much more moderate since June (mainly driven by car exports). Despite the close link between the two, imports showed little change amid slowing exports - the impact was, in part, cushioned by a rise in imports aimed at satisfying domestic demand and, in particular, investment activities. As a consequence, the trade balance deficit has slightly widened.

II.2. The Present and Anticipated Development of External Conditions

While, since the beginning of this year, macroeconomic indicators have consistently shown that the recovery in the global economy is well on track, the geopolitical situation, soaring oil and energy prices and concerns over their impact on global economic growth continue to undermine confidence in the financial markets. The US economy together with strong growth in China are still the main driving force behind the global economy. With more solid macroeconomic results and the inflationary situation within market estimates, the FED was able to nudge interest rates off their 46-year lows. Global economic growth was also fuelled by a more robust economic growth inside the euro zone, however, according to the recommendations spelled out by the European Commission, achieving sustainable economic growth with the necessary job creation will require the implementation of structural reforms to continue in several countries.

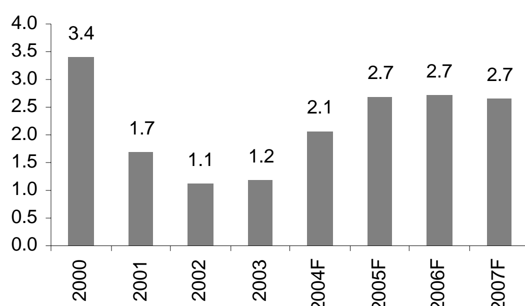
Forecasted economic growth in selected countries

	2003	2004F	2005F	2006F
USA	3.1%	4.4%	3.0%	2.9%
Eurozone	0.6%	2.1%	2.0%	2.2%
Japan	2.4%	4.2%	2.1%	2.3%
Germany	-0.1%	1.9%	1.5%	1.7%
Czech Republic	3.1%	3.8%	3.8%	4.0%

Source: European Commission Autumn 2004 forecasts

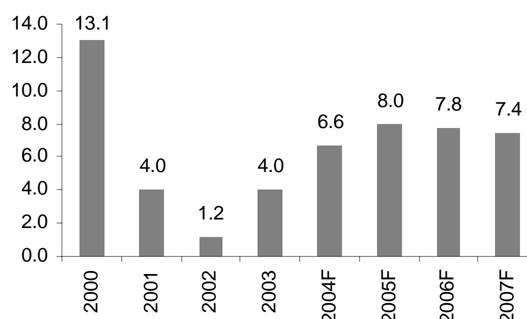
In general, compared to the spring forecast, the 2004 economic growth estimates have slightly improved, however a more pronounced slowdown is expected in 2005 and 2006 mainly as a result of the upward pressure on oil prices. During 2004, adverse geopolitical developments and natural conditions took a toll on oil production, sending oil prices to record highs. While up until now, the global economy more or less managed to resist the growing oil prices, indices of business and consumer confidence point to an increased risk associated with high oil prices. As an open economy, Slovakia's economic performance will be largely hinged on the development of the global economy. While, over the past few years, export-weighted real GDP[2] growth of all Slovakia's major trade partners has experienced a significant dip, this negative trend has been reversed and in the coming years, growth is likely to pick up from 1.2% in 2003 to 2.7% in 2005, according to OECD forecasts. The acceleration in the economic growth of these countries should translate into a growing appetite on the demand side which, in turn, should drive their imports - and Slovakia's exports.

Weighted GDP growth of Slovakia's business partners (%)



Source: OECD, Ministry of Finance

Weighted growth in the imports of Slovakia's business partners (%)



Source: OECD, Ministry of Finance

[2] The exports to these countries as a percentage of Slovakia's total exports were used as weights. For the years 2004-2007, the 2003 weights were used.

II.3. Forecasted Development of the Real Economy and of the Labour Market

Forecasts are revised taking into account the most recent development in the Slovak economy as well as the most recent forecasts by the EC and OECD concerning future development. We still anticipate a moderate appreciation of the EUR/SKK exchange rate and the intentions set out in Slovakia's economic policy are expected to be fulfilled. However, our assumptions regarding oil prices were revised to 40 US dollars per barrel[3]. The technical methods and general principles used to produce the forecasts for Slovakia's Convergence Programme remained unchanged.

According to forecast updates, it is anticipated that, over the forecast period to 2007, the potential growth of the Slovak economy will move up to around 5.0%. The main growth factors should be better productivity, more capital as well as stronger structural employment. This should also underpin the real convergence process.

We count on that, with the exception of 2005, economic growth should be driven by a combination of domestic and foreign demand until 2007. As regards 2005, the external balance of goods and services is still expected to be in negative territory as a result of an increase in investment-related imports. The stable and positive contribution of domestic demand to the growth of the economy should be upheld by a stable increase in real wages, which, in turn, should drive household consumption.

During the first six months of 2004, the gross average wage growth remained ahead of expectations, so the 2004 forecasts were upgraded from a decline in real terms to a 1.6% growth, which is likely to translate into a stronger increase in private consumption at around 3%. In the coming years, we anticipate the average wage to grow in real terms at an even brisker pace (3%), which, however, should not get ahead of the labour productivity growth. Under these conditions, the real consumption of households may, in the timeframe under review, grow at higher pace of around 4% and reach a level of around 56% of GDP.

Government consumption will continue to develop in line with the main fiscal policy objectives and measures[4]. As a consequence, government consumption is the slowest moving GDP component. In the context of the updated general government spending forecast (see Chapter III.3), it should rise by 0.9% in 2004 and by around 1.5% to 2.2% in the coming years.

Having regard to the development observed in Q2 of 2004 and, in particular, the investment activities that were launched, we continue to expect a pick-up in fixed capital formation. The fixed capital formation in 2004, however, is expected to come in at a modest 3.3%. This growth should peak in 2005 (7.5% growth). The actual progress of investment activities will be, for the most part, determined by the timing chosen for the imports of production technologies going into the future car factories.

Foreign demand for goods and services will be, to a large extent, driven by the inward investment going to Slovakia, the increase in the existing export capacities, Slovakia's competitiveness as well as by the strength of the economic growth inside the EU. Current forecasts on the growth of exports and imports until 2007 are slightly ahead of the spring

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[3] The latest forecasts by several foreign experts expect oil prices to peak in 2005 at around 45-46 USD per barrel, which suggests that the risk associated with the submitted forecast concerning Slovakia's economic development is limited.

[4] The general government deficit should drop below the 3% of GDP reference value in 2006 or 2007; this forecast already takes account of the revenue shortfall in the pay-as-you-go pillar resulting from pension reform.

forecasts. Besides 2005, the contributions of the net foreign demand to GDP growth will be in positive territory and higher than forecasted in spring.

Employment is lagging behind expectations mainly due to efforts to streamline health care and education, which is most likely to result in the stagnation of employment in 2004. In the subsequent years, the average rate of increase will stabilize at 0.6-0.9%. In 2004, unemployment should reach the 18.5% mark and reductions in the coming years are anticipated to be less pronounced as a result of the introduction of a higher retirement age.

Growth and the associated factors (%, except as stated otherwise)

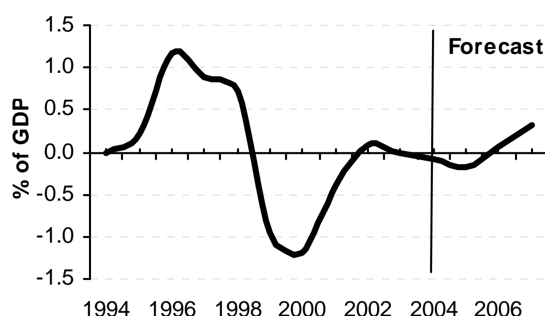
	ESA code	2003	2004F	2005F	2006F	2007F
GDP growth at constant market prices (7+8+9)	B1g	4.2	5.0	4.5	5.1	5.4
GDP level at current market prices, bn. SKK	B1g	1 195.8	1 319.9	1 407.4	1 503.8	1 611.3
GDP deflator (year-on-year growth)		4.7	5.1	2.0	1.7	1.7
CPI Change (annual average)	100	8.5	7.8	3.3	2.8	2.5
Employment growth*		1.8	0.0	0.6	0.6	0.9
Labour productivity growth**		3.4	5.0	3.8	4.4	4.4
Growth sources: percentage changes in constant prices						
1. Private consumption expenditures	P3	-0.4	3.0	4.1	3.9	4.0
2. Government consumption expenditures	P3	2.9	0.9	1.5	2.2	1.5
3. Gross fixed capital formation	P51	-1.2	3.3	7.5	6.0	3.3
4. Changes in inventories and net acquisition of valuables as % of GDP***	P52 + P53	-0.7	0.4	0.8	0.6	-1.1
5. Exports of goods and services	P6	22.6	12.4	10.5	13.9	12.8
6. Imports of goods and services	P7	13.8	11.8	11.1	13.0	9.6
Contribution to GDP growth						
7. Final domestic demand (1 + 2 + 3)		0.1	2.6	4.3	3.9	3.1
8. Change in inventories and net acquisition of valuables (= 4) ***	P52 + P53	-2.3	1.1	0.4	-0.2	-1.8
9. External balance of goods and services	B11	6.4	1.2	-0.1	1.3	4.1

** According to the labour force survey*
*** GDP growth at market prices per employed person at constant prices*
****Including statistical discrepancy*
Source: Statistical Office, Ministry of Finance

II.4 Cyclical Position

Current forecasts confirm the originally anticipated negative output gap in 2004. All in all, Slovakia's economy will underperform its potential output by 0.1%. The fairly robust economic growth (5.0%) will be driven by the growth of productivity in exporting industries and by the growth of capital stock.

Output gap development (% of GDP)



	GDP growth (%)	Potential output (%)	Output gap (% of GDP)
2001	3.8	2.9	-0.4
2002	4.4	3.9	0.1
2003	4.2	4.3	0.0
2004F	5.0	5.1	-0.1
2005F	4.5	4.6	-0.2
2006F	5.1	4.8	0.1
2007F	5.4	5.2	0.3

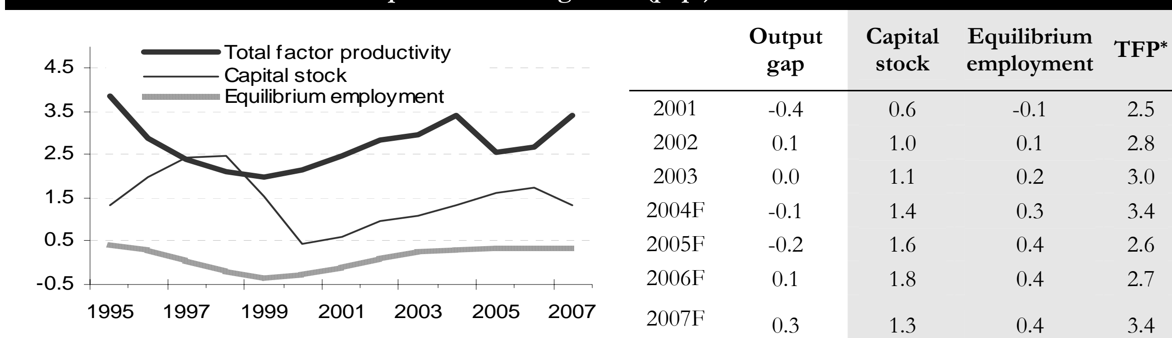
Source: Ministry of Finance

For the 2005-2007 period, the increase in total factor productivity and potential employment is expected to benefit from inward investment; from a short-term perspective, a slight boost came in the form of Slovakia's accession to the EU and from a medium-term perspective, the main drivers will be the reforms currently underway. With two major car producers to launch production in the second half year of 2006 and in early 2007, the gap will gradually close and, as of 2006, the economy should slightly outperform its potential output.

Like before, the production function approach recommended by the European Commission was used to estimate the output gap. However, problems common to new EU Member States - such as taking care that foreign direct investment translates into labour productivity growth – still persist. All estimates concerning the effect triggered by the launch of production at the PSA Peugeot Citroën and KIA Slovakia plants in 2006 and 2007 are based on the experience Slovakia has had with the launch of a new production line by major car producer VW. According to estimates, total factor productivity (TFP) should, in the coming years, remain stable at around 2.5% per year, whereby, the aforementioned launch of operation should cause the average annual TFP level to surge to around 3.0% in 2006 and 2007. The potential output estimate also takes account of the moderate effect associated with Slovakia's membership in the EU as of May 2004.

According to the technical method of assessing equilibrium employment using the HP filter, employment was above its equilibrium value in 2003. The growth of structural employment during the 2005-2007 period is projected to reach around 0.8% annually. Due to constant supply-side shocks, it appears desirable to continue working with conservative forecasts and projections. This applies to the expected development of both employment and TFP during the 2006 and 2007 period.

Contributions of main factors to potential GDP growth (p. p.)



	Output gap	Capital stock	Equilibrium employment	TFP*
2001	-0.4	0.6	-0.1	2.5
2002	0.1	1.0	0.1	2.8
2003	0.0	1.1	0.2	3.0
2004F	-0.1	1.4	0.3	3.4
2005F	-0.2	1.6	0.4	2.6
2006F	0.1	1.8	0.4	2.7
2007F	0.3	1.3	0.4	3.4

** Total Factor Productivity*
Source: Ministry of Finance

II.5 Expectations in the Monetary Area

Inflation measured in consumer prices stayed on track with initial forecasts in 2004. The major price drivers introduced earlier this year were the adjustments of regulated prices and the introduction of a flat VAT rate (currently at 19%). No dramatic changes were associated with Slovakia's EU accession or with the adoption of the Common Agricultural Policy. The development in consumer prices was, in part, driven by the fuel price increase resulting from the soaring oil prices on global markets. So far, core and net inflation[5] indicates that demand-side pressures are still limited. The secondary effects of administrative interventions were moderate this year.

[5] Net of the impact of administrative adjustments and seasonality of food prices.

Core inflation (averaging 2.8% for the first nine months of 2004) is hovering around the reference value[6].

Impact of administrative measures on the year-on-year inflation rate (p.p.)				
	2004F	2005F	2006F	2007F
Regulated prices contribution	3.6	1.2	0.8	0.5
Contribution of the adjustment in indirect taxes, translated into non-regulated prices	1.1	0.0	0.0	0.3
Administrative interventions in total	**4.7**	**1.2**	**0.8**	**0.8**
HEADLINE INFLATION (average)	**7.8**	**3.3**	**2.8**	**2.5**

Source: Ministry of Finance

Expected average inflation in 2004 was revised downward mainly due to favourable developmet of food prices in 2004 (lower-than-expected price increase after EU entry) and moderate secondary effects of adminsitrative measures. Based on the estimates of regulatory authorities, no significant increase in regulated prices is expected in the coming years. This will allow headline inflation to fall significantly. Slovak authorities expect to reach the 'Maastricht' level by the end of 2007 at the latest.

Interest rates are also following the trend plotted in Slovakia's first Convergence Programme. According to the Convergence Report prepared by the ECB, long-term interest rates in Slovakia (currently 5.1%) are already under the reference value 6.4% (August 2004), thus Slovakia satisfies the interest-rate convergence criterion. As regards the time structure of interest rates, we see signals of stagnation or moderate growth at the long end of the yield curve. The yields on 10-year government bonds remain virtually unchanged irrespective of key interest rate cuts by the NBS.

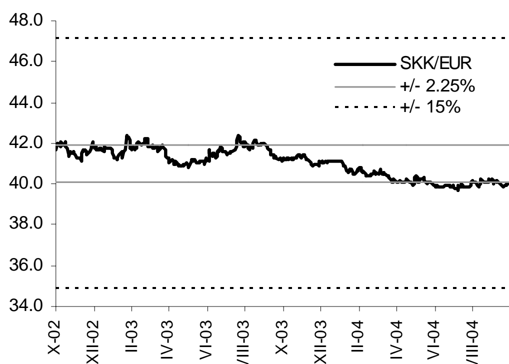
Although long-term interest rates are expected to gradually grow in the coming years, this upside trend should move in tandem with the development in the euro zone.

During the past three quarters of 2004, the SKK exchange rate has been fluctuating within the range of 39.7 – 41.1 SKK/EUR, the main drivers being exchange rate movements of currencies in neighbouring countries inside the region, political events as well as the effort by the Central Bank to eliminate excess volatility through interventions on the forex market.

The real effective exchange rate (REER) [7] has been on an upward trend for the past couple of years. For the years to come, the anticipated development of macroeconomic indicators coupled with growing labour productivity, reforms and consolidation in the fiscal area and, in the medium-term, with inward FDI creates the necessary prerequisites for a favourable trend (appreciation) of the SKK exchange rate compared with the Euro. Determining the central exchange rate parity will be essential when entering the ERM II and in particular setting the conversion rate when adopting the Euro. Having regard to its historic development and the applicable admission criteria, the target date of adopting the Euro in Slovakia is 2009, which requires ERM II entry in the first half year of 2006 at the latest.

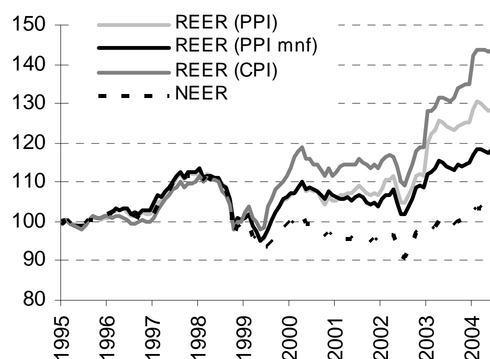
[6] EU enlargement and a higher number of countries participating in the determination of the reference value resulted in better conditions for the reduction of the reference value, making the Maastricht criterion more stringent.
[7] reflects real apprediation or depreciation of the Slovak koruna vs. a representative currency basket.

Development of the SKK/EUR exchange rate



Source: Reuters

NEER and REER development



Source: NBS

II.6 External Sector Outlook

The 2004-2007 trade balance forecast is updated in line with the actual trade balance development for the first eight months of 2004 and in line with the updated forecasts of domestic demand, price deflators and foreign demand. The updated version confirms the original assumptions that the trade balance would significantly improve by 2007.

As of June, MoF expectations are becoming true in that Slovakia's exports would gradually slow down in 2004 and 2005, but despite higher figures in actual and projected turnover compared to the original forecasts, the situation has slightly worsened in terms of balance. The deficit should be peaking in 2005 due to slowing exports and accelerating imports (imports to cover both the capital investments and consumer demand). The deficit is expected to drop (0.5 % GDP) by 2007 due to rising exports, particularly from the automotive industry. The foreign trade forecasts have been slightly adjusted, yet the major factors of influence outlined in the Convergence Programme remain intact.

The update of the income balance[8] forecast for 2004 also includes an outflow of funds paid out in dividends to a foreign direct investor in the second quarter of 2004. The changes in the forecast of current transfers reflect a more specific vision of the flow of funds paid to/received from the EU budget.

Development on the current account (balance of payments) and its components (% of GDP)

	2003	2004F	2005F	2006F	2007F
Trade balance	-2.0	-2.7	-3.5	-3.1	-0.5
Exports	67.2	68.2	68.4	73.4	79.5
Imports	69.1	70.9	72.0	76.5	80.0
Balance of services	0.7	1.0	0.8	0.8	0.7
Income balance	-0.4	-0.9	-1.0	-1.0	-1.0
Current transfers	0.8	0.4	1.0	1.2	1.1
Current account	-0.9	-2.2	-2.8	-2.1	0.3

Source: Ministry of Finance

The current account balance has been adjusted, mainly due to the foreign trade deficit development, to -2.2% of GDP in 2004 and -2.8% of GDP in 2005. The deficit is expected to be safely offset by a surplus on the financial account, a substantial part of which results from a higher influx of foreign direct investments. In the years to follow, the overall balance should

[8] Forecasts do not take into account the expected methodological change regarding reinvested profits.

continue to improve, also under the influence of the balance of services and contributions from the EU; in 2007, the current account may show a slight surplus of about 0.3% of GDP.

Compared to 2006 and 2007, the inflow of foreign direct investment in 2004 and 2005 will be higher in connection with the construction of two car plants in Slovakia, as well as other investment (e.g. Samsung) However, the FDI volume will also be positively influenced by the successful completion of projects-in-progress undertaken by investors with a longer presence on the Slovak market.

The total foreign exchange reserves of NBS are growing at a slightly faster pace than expected, and the current estimates of development until 2007 are moderately higher. In October 2004, the NBS reserves amounted to USD 13.3 billion; this trend is expected to continue until the end of 2004 because the government and NBS revenues will outweigh expenditures. Their volume will cover around 5.1 months worth of imports of goods and services. In 2005–2007 the foreign exchange reserves will decrease as loan repayments outweigh disbursements of new loans and privatisation proceeds decline. The average coverage of the imports of goods and services are expected to drop from 4.6 months in 2005 to 4 months in 2006 and to 3.4 months in 2007.

The total gross foreign debt of the Slovak Republic stood at USD 18.7 billion in June 2004, up by almost USD 3.4 billion year-on-year. As a result, the total gross foreign debt reached 3,477 USD per capita. The increase is mainly attributable to the higher long-term foreign debt of the government resulting from bond issues, increased influx of short-term liabilities in the sector of commercial banks, and higher liabilities vis-à-vis direct foreign investors. No significant changes in this figure are expected in the following years.

II.7. Risks of the Forecasts and Alternative Scenarios

First of all, it is important to stress that the Committee on Macroeconomic Forecasts (Annex No. 2) evaluates the medium-term forecasts of the Ministry of Finance as realistic or slightly conservative.

Given the fact that the influence of the political situation and of the natural forces is part of each economic forecast and is virtually unpredictable, attention will focus exclusively on the specification and assessment of the most probable risks of economic character having a major impact on the development of the economy.

The latest development confirms the legitimacy of simulations and discussions about the risks specified originally in Slovakia's Convergence Programme – about the influence of higher appreciation of the exchange rate, lower than originally expected growth in foreign demand and higher growth in labour productivity. Model simulations (resluts in CP from May 2004) of partial influences gave us an idea of their size, extent, timing and thereby also of the gravity of individual risk types if engaged under the *ceteris paribus* assumption.

1/ For example, it became apparent that, in theory, a higher-than-expected appreciation of the exchange rate[9] would speed up the disinflation process and drive down interest rates, resulting in more consumption and higher imports (in the absence of an adjustment on the production side of economy), which would ultimately hurt competitiveness. In the following, the adverse effect would spill over to the trade and current account deficits, GDP

[9] NBS intervenes against high volatility of the exchange rate and against any development that significantly digresses from the development of the macro-economic fundamentals. Moreover, it is anticipated, that from the first half of 2006 until June 2008, Slovakia will be in ERM II regime with fixed central parity SKK/EUR.

growth, unemployment and nominal wages. A serious memento is the long-term negative impact on the external balance. This simulation showcases the essential role of a correctly determined central parity when entering the ERM II and, in particular, the conversion rate when joining the euro zone.

2/ The weaker-than-expected performance of Slovakia's trade partners and the resulting sluggish exports may result in the widening of the current account deficit, causing the Slovak koruna to depreciate, GDP[10] growth to slow down and the negative output gap to widen. It would have an adverse impact on employment, wages, consumption and investment; that, in turn, would lead to lower inflation and weaker imports and, as a consequence, to a narrower current account deficit. At the same time, there would be a room for gradual interest rate cut in order to trigger a pick-up in investment and a recovery in the economy.

3/ As for upside risks, a higher-than-expected labour productivity growth would boost competitiveness in the economy and the upside pressure on the potential output would widen the negative output gap, conditioning the economy for interest rate cuts (with a short-term negative impact on the exchange rate) to underpin consumption and investment. The boost in competitiveness would drive exports and dampen imports, mitigating the current account deficit and strengthening the real exchange rate. Stronger investment and consumption will, however, put a drag on the improvement of the external balance. A more robust economic growth will result in an improvement of the labour market.

The estimated rise in productivity is instrumental to potential output and economic cycle forecasting. Productivity growth in Slovakia has accelerated significantly over the recent period, however, productivity forecasts based on the extrapolation of historical data into the future are rather conservative. In a relatively small open economy of the likes of Slovakia, non-recurring shocks (i.e. launch of new manufacturing operations) are prone to considerably speeding up productivity growth.

It is apparent that getting more complex and realistic picture of all development scenarios relevant for the Slovak economy requires a broader perspective of all the potential factors. In transforming economies, and in Slovakia in particular, exports represent a key growth factor for the economy[11]. As a matter of fact, exports are driven in parallel by several factors (which is why any simulation of the final impact must rely on a reasonable combination of these factors) – the general trend in foreign demand, ability of Slovakia's producers to adapt both in terms of quality and product range (overall competitiveness), method of setting up and launching new plants developed in Slovakia by both foreign and domestic private investors (possible impact of positive shocks triggered by higher-than-expected productivity growth), relative exchange rate development and, in particular, development of energy prices. Energy imports as a percentage of Slovakia's total imports are fairly sizeable (around the 13% marks). The growth in energy prices is not only putting a drain on foreign demand and Slovakia's exports, but also runs up production costs for businesses, eating away at corporate profits and hurting investment, wages, consumption, employment and Slovakia's economic growth as such. As a consequence, there are also adverse impacts on budgetary revenues and expenditures and on the progress of the general government financial consolidation.

Econometric analysis shows that the relative crude oil price (in SKK) elasticity of fuel prices (gasoline and diesel) is approximately 0.45. It appears that, until the end of 2004, higher oil prices will have little impact on the average inflation forecast. Of course, should these price levels persist, the impact on the inflation will be higher through weaker export demand.

[10] According to the simulations, 3% lower export compared to the baseline could lead to a decrease in GDP growth of 0.3 basis points.

[11] In 2003 net export contribution to GDP growth reached 6.5 percentage points.

Some experts assume that in 2005, oil prices will hover around the 45 USD/brl mark. The average inflation could increase by 0.2 percentage point should this assumption materialize. As a consequence, real growth of domestic demand could slightly decelerate. However, there is still a question mark over the development of the SKK/USD exchange rate.

III. GENERAL GOVERNMENT BALANCE AND DEBT

III.1 Medium-Term Fiscal Framework

The main fiscal objective of the government is the general government finance consolidation. In the medium term, this means reducing the deficit below 3% of GDP in 2006 net of the costs associated with launching the second pillar of the pension system reform. However, given the decision of Eurostat of March this year, the Maastricht criterion can only be satisfied in 2007.

Given the fact that the scale of the pension system reform shortfall is a matter of uncertainty, as it depends on the number of contributors, who will decide during 2005 and in the first half of 2006 to participate in the fully-funded pillar, the government formulates and presents its basic goals as deficits net of the shortfalls of the pension system reform. This decision is in the interest of the government's credibility, because it can better control deficits defined in this way better and at the same time it is in accordance with the Eurostat decision of September, concerning the transition period (until March 2007) for reporting the costs of the pension system reform.

Minimum changes in the medium-term fiscal framework occurred when compared to the Convergence Programme of the Slovak Republic of May 2004, whereas the objective of reducing the general government deficit including the costs of the pension system reform to 3% of GDP until 2007 remains unchanged. This is enabled by the general government financial development in 2004 which is in accordance with this year's budget. It also documents the determination and consistency of the government's policy.

Balance of general government revenues and expenditures (% of GDP, ESA 95)

	2003E	2004B	2004E	2005B	2006B	2007B
Total revenues	**36.3**	**36.2**	**35.3**	**37.1**	**36.9**	**36.9**
Taxes	18.2	17.9	17.6	17.4	17.3	17.3
Social security contributions	13.9	13.1	12.5	13.5	13.5	13.4
Non-tax revenues	4.2	3.8	4.0	4.0	3.6	3.7
Grants and transfers	0.0	1.4	1.2	2.2	2.5	2.5
Total expenditures	**40.0**	**40.2**	**39.1**	**40.4**	**39.8**	**38.8**
Current expenditures	36.9	36.4	35.4	36.4	35.9	34.9
- Wages	7.4	7.2	7.0	7.0	6.9	6.8
- Goods and services	5.2	5.2	5.3	5.4	5.4	5.2
- Subsidies and transfers	21.8	21.6	20.8	21.7	21.2	20.6
- Interest	2.6	2.5	2.3	2.4	2.3	2.3
Capital expenditures	3.1	3.8	3.8	4.0	4.0	3.9
Primary balance*	-1.9	-2.0	-1.9	-1.4	-1.0	0.1
Net borrowing (-)/lending(+)	**-3.7**	**-4.0**	**-3.8**	**-3.4**	**-2.9**	**-1.9**
Pay-as-you-go pillar revenues shortfall	0.0	0.0	0.0	-0.4	-1.0	-1.1
Net borrowing (-)/lending(+) including PAYG shortfall	**-3.7**	**-4.0**	**-3.8**	**-3.8**	**-3.9**	**-3.0**

** Calculated as total balance exclusive of net interest costs (interest paid minus received by public administration). Primary balance in the last Convergence Programme only contained paid interest.*

Source: Ministry of Finance

Consolidation effort of the government is reflected in year-on-year decrease of the public finance deficit by 0.4 percentage point of GDP in 2005, by 0.5 percentage point in 2006 and 1 percentage point in 2007. The main sources of consolidation will be high growth of the economy and structural reforms that were described in the last Convergence Programme.

When evaluating the ambitiousness of the general government consolidation several facts need to be taken into account. Key reforms focused on the consolidation of general government finance were implemented in 2003 and 2004, when a significant reduction of the deficit from 5.7% of GDP in 2002 took place. The government did not intend to prepare – bearing in mind revenues from the EU budget – a substantially restrictive budget for 2005 and 2006. The deficit as a share of GDP will decrease, however, expenditures in constant prices will grow. At the same time, higher emphasis was laid on allocation of resources. Program budgeting became an integral part of the budget process, which will contribute significantly to the streamlining of the general government finances in the long-run.

To a certain degree, consolidation is complicated by the accession to the EU and the reform of the pension system. Despite the fact that the accession to the European Union is expected to have a positive impact on economic development, its net effect on general government finance will be negative in the medium term contrary to the country's net financial position. The shortfall in revenues due to the introduction of the second pillar of the pension reform will have similarly negative impact on the public sector balance if the deficit is evaluated including the costs associated with the reform. This applies in spite of the fact that the pension reform will not lead to an increase in domestic demand.

Effects on general government finances (% of GDP, ESA 95)

	2004F	2005B	2006B	2007B
EU accession	-0.6	-1.4	-1.2	-1.2
Launching 2nd pillar of pension reform	0.0	-0.4	-1.0	-1.1
TOTAL	**-0.6**	**-1.8**	**-2.2**	**-2.4**

Source: Ministry of Finance

The medium-term fiscal framework presented herein is consistent with the draft of general government budget for 2005 to 2007 that has already been approved by the government and will be subject to approval in the National Council of the Slovak Republic. It is the first multi annual budget and at the same time it focuses more explicitly on public and not only central budgets.[12] The complexity and the medium-term character of the budget strengthen the binding effect of the objectives presented in this medium-term fiscal framework.

The 50% rule was taken into consideration in the preparation of the budget for 2005 to 2007, as a criterion for distinguishing market and non-market entities among subsidised organisations. It means harmonisation with the ESA 95 methodology in defining the general government sector, where only those organisations that have less than 50% of the costs covered by sales proceeds are considered subsidised organisations. Entities that did not satisfy this criterion will be excluded from the general government sector from January 2005. They include especially health care facilities. This rule was not implemented in the previous Convergence Programme and the general government finance balance included all subsidised organisations irrespective of their source of costs coverage. Due to that, the balance of general government in the last Convergence Programme was higher both on the

[12] The National Council of the SR approves the act on state budget for the respective budget year and takes into account the draft of the budget of public administration for three budget years. Although the budget is binding only for the next budget year, adjustments in the following budget year will only be possible in justified cases.

side of revenues and expenditures by approximately 1 percentage point of GDP each year when compared to this Convergence Programme. It concerns non-tax revenues and wage, goods and services and capital expenditures on the expenditures side. This reduction is therefore not the consequence of the government's policy but rather results from a change in methodology.

Various general government subsectors will each be contributing to the overall deficit in their own way. The bulk of the deficit will be concentrated in the state budget, giving the government additional control over targets and stabilisation measures and ensuring greater transparency. Social security funds reforms were designed to ensure that the funds are managed so as to have balanced budgets in the long run. However, the transition costs of the pension reform will have to be addressed by transfers from the central government. Although the government has no direct control over the management of municipal budgets, the latter are projected to be broadly balanced. This should be provided mainly by fiscal rules and naturally also by sufficient financial backing of the competences of municipalities which is related to the launch of the fiscal decentralisation project.

Net borrowing (-)/lending (+) at different levels of general government (% of GDP, ESA 95)

	2003E	2004B	2004E	2005B	2006B	2007B
Central government	-4.2	-4.3	-3.4	-3.9	-3.5	-3.1
Municipalities	-0.1	0.0	-0.1	0.0	0.0	0.0
Social security funds	0.5	0.3	-0.3	0.5	0.5	1.2
General government, total	**-3.7**	**-4.0**	**-3.8**	**-3.4**	**-2.9**	**-1.9**
Pay-as-you-go pillar revenues shortfall	0.0	0.0	0.0	-0.4	-1.0	-1.1
General government deficit including PAYG shortfall	**-3.7**	**-4.0**	**-3.8**	**-3.8**	**-3.9**	**-3.0**

Source: Ministry of Finance

Fiscal decentralisation will be launched on 1 January 2005. It follows up on the devolution of competences from the bodies of central administration to municipalities and self-governed regions that was taking place from 2002 to 2003. Key feature of fiscal decentralisation is the transition of competences from non-systemic financing of the competences of the local governments by means of subsidies to the tax based financing. This will change the manner in which tax revenues are reallocated among public administration entities.

The current development of the general government finances is consistent with expectations and the government's fiscal objectives for this year, creating a good basis for the fulfilment of financial objectives for the period of 2005 to 2007. The current estimate of the public administration deficit for 2004 is 3.8% of GDP, which is by 0.2 percentage points less than the approved budget and by 0.1 percentage points less than the objective of the government. Compared to the budget, the development of tax revenues and interest expenses for public debt is better, which is a consequence of the positive macroeconomic development and correct quantification of the tax reform. Concerning non-tax revenues, the revenues from dividends are also higher. Savings resulting from non-disbursement of expenditures and lower co-financing of the EU projects are decisive on the expenditures side. On the contrary, higher than budgeted expenditures are expected due to the use of funds from the budget chapters that were not disbursed in 2003 and the government at the same time decided to increase the expenditure for some chapters. Worse economic results of the Social Insurance Agency were identified among other items of the general government finances. At the moment, total revenues (excluding revenues from the EU budget) are estimated to be only by SKK 56 million higher when compared to the adjusted budget (municipalities' budgets taken into account). Therefore it can be said that the recommendation of Ecofin from July of this year to use higher-than-budgeted revenues for the reduction of deficit will be important

mainly for the next period. In this respect it is important that according to the new budget proposal, higher-than-expected revenues could be used to increase expenditures only by 1%.

The main risk factors for the coming years include VAT revenues and social security contributions. Measures prepared to provide for more effective collection should eliminate a major part of that risk. On the positive side, priority importance is attributed to conservative macroeconomic projections and a higher contribution of the tax reform in the area of income tax.

III.2. General Government Revenues

In 2003 to 2007 consolidated total general government revenues are projected to grow by 0.6 percentage points to 36.9% of GDP. Net of EU funding, revenues are expected to decline by 1.9 percentage points.

Tax revenues

On 1 January 2004, a complex tax reform was launched in Slovakia. One of the major budgetary risks for this year was the correctness of the quantification of its impact on the budget. According to the current estimate, the tax revenue will be slightly higher than budgeted. The higher-than-projected collection of personal and corporate income tax is offset by lower revenues from VAT; which, moreover, is still a source of uncertainty, since its collection is influenced, besides the unification of individual rates to 19 percent, by the EU accession and changes in the area of excessive deductions.

For 2005-2007 no substantial legislative changes have been considered with respect to tax revenues. Turning to personal income tax, the tax bonus for children is expected to rise slightly in 2005; municipalities are expected to increase real estate tax within the financial decentralisation in that same year; and in 2007, tobacco excise taxes are projected to be hiked in connection with the approximation of the national legislation with the EU directive setting out the minimum rates. Real estate transfer tax will be abolished effective January 2005.

Social security contributions

On 1 January 2004, a social system reform was launched in Slovakia, including a complex pension reform. The changes resulted in a reduction of the payroll tax by 3 percentage points for employers and in an increase of 0.6 percentage point for employees. The reduction of the tax burden was, to a certain extent, offset by an increase in the maximum assessment base, which was fixed as three times an average wage for the previous period with a majority of funds. In total, however, the share of social security contributions in the average wage declined.

The fully-funded pillar of the pension system will be put in operation on 1 January 2005. There will be no change in the total sum of social insurance contributions of 22.75%; however, the distribution into individual funds will be changed. The pay-as-you-go system will swallow 9% of the gross wage, as will the fully-funded pillar. The remaining 4.75% will flow into the reserve fund, which is to cover mainly the shortfall forming in the pay-as-you-go pension system.

Besides one-off factors, the huge difference between the contributions into the Social Insurance Agency between 2004 and 2005 has been caused mainly by the expected

improvement in the collection success rate (following the corrective measures), which shrunk this year due to a delay in contribution billing.

From 1 January 2005, a new system of health insurance will be in effect. It will tighten budgetary constraints and strengthen funding from sources other than the public ones. The change will unify the maximum assessment base with that in the social insurance system. Contribution rates will not change, except for an increase in the rate for persons employing the physically disabled. Contributions paid from the state budget for and on behalf of the economically non-active part of the population will be mandatory and linked to the evolution of average wages in the preceding period. These measures will bring additional SKK 4.5 billion into the system. By the same token, non-systemic transfers from the Social Insurance Agency will be cancelled.

The government's consolidation efforts have thus far failed to create room for further reduction of the tax burden in the medium term. The introduction of the flat tax has substantially reduced marginal tax rates; on the other hand, the relatively-high social contributions create a rather high tax wedge between the total labour cost and the net, after-tax income of employees. The responsible approach to the issue of future costs of population ageing, however, rules out any dramatic reduction of social contributions, even in the long term. Despite that, Slovakia is among the countries with the lowest overall tax burden in both the European Union and the OECD. Nevertheless, potential restructuring of taxes and contributions within the existing burden cannot be ruled out.

Tax quotas I and II (% of GDP, ESA 95)

	2003E	2004B	2004E	2005B	2006B	2007B
Tax quota I (taxes)	18.2	17.9	17.6	17.4	17.3	17.3
Tax quota II (taxes and social contributions)	32.1	31.1	30.1	30.9	30.8	30.7

Source: Ministry of Finance

With negligible legislative changes, the major source of motion, as well as the major risk for revenues from taxes and contributions, will be the development of the macroeconomic environment. In the past, Slovakia was characterised by a declining tax quota II, even in an environment with no legislative changes. It was based on several reasons. One of the reasons were taxes, whose bases were not elastic with respect to the GDP growth: as, for example, gift tax, inheritance tax and real estate transfer tax. They were discontinued by the tax reform. Maximum assessment bases were fixed for social contributions, relatively relieving the burden of higher income earners. Through the reform, the assessment bases were pegged to the average wage growth. In the past few years, the structure of economic growth driven by export growth rather than the domestic consumption also contributed to the reduction of the taxes as a percentage share of GDP. In the medium-term, the tax quota II is expected to stabilise and decline by 0.2 percentage point between 2005-2007.

Non-tax revenues

In 2005-2007, non-tax revenues should fall from 4.0% to 3.7% of GDP. A positive impact on the figure is expected to result from corporate dividend revenues provided by companies with state ownership, as well as the prepared gambling legislation. Increased revenues are also expected from the introduction of new, EU-type travel documents. A negative impact is projected with respect to the founding of the National Motorway Corporation as of 1 January 2005, which will swallow the revenues from the sale of motorway vignettes. The Motorway Corporation will not be included in the general government sector; therefore, a shortfall is expected in general government revenues to the tune of 0.1% of GDP.

Grants and transfers

Revenues from the EU budget will gradually rise from 1.2% of GDP in 2004 to 2.5% of GDP in 2007. In 2005, the use of EU funds is expected to be higher, mainly due to more considerable use of monies from structural funds and the Cohesion Fund. Moreover, the increase of receivables from the EU budget at about 0.3% of GDP has a positive impact on the general government balance calculated under the ESA 95 methodology. A persistent risk can be found in the transfer of money between individual budgetary years.

III.3 General Government Expenditures

According to the budget approved by the government, consolidated general government expenditures are projected to decline in 2003 to 2007 by 1.2 percentage point to 38.8% of GDP. Increased efficiency, strong growth and structural reforms are the most important factors behind this decline. On the other hand, investment expenditures are expected to increase.

Current expenditures

Between 2003 and 2007, the expenditures for wages, salaries and other service employment compensations will fall from 7.4% to 6.8% of GDP. Despite that, the nominal growth of funds earmarked for wages provides a good basis for real growth in wage earned by public sector employees in each of the monitored years. The budget prepared for 2005 – 2007 took into account, among other things, the regional education system reform, which expects a gradual reduction in the number of teachers, by 3% a year. On the other hand, however, in an effort to make work in the education sector more attractive, better financial conditions were formed for teachers who are new to the profession.

Expenditures for goods and services in 2005-2007 are influenced mainly by the allocation of European Union budgetary funds and the provision of co-financing from the state budget. The volume of funds allocated in this way will rise to 0.3% of GDP by 2007. Thanks to the above, the expenditures for goods and services will remain constant at 5.2% of GDP.

The volume of current expenditures for subsidies and transfers will constitute the most considerable contribution to fiscal consolidation. By 2007, they should fall by 1.2 percentage point to 20.6% of GDP. The most important expenditure categories are described below.

Agricultural subsidies represent 60% of all current subsidies to business entities from public resources. The year 2004 saw the subsidies to farmers grow on the year, and the growth will continue, at a more moderate pace, even in 2005-2007.

The payment for expenses incurred in connection with road and railway transport services provided in the public interest represents, besides agriculture subsidies, the second largest volume of money. In digits, the volume is stable at 0.6% of GDP. Payments to ŽSR (the Slovak railway operator) in the amount of 0.5% of GDP account for the largest portion of these expenditures. The remaining expenditures will be used by the regional self-administrations to compensate bus carriers for providing discounts on fare and for the provision of transport on financially-demanding routes. Another form of transport subsidies is the support of municipal transport in five regional capitals of Slovakia. The fiscal decentralisation has fully transferred the decision-making authority to local self-

governments, which may decide in what form and to what extent they will support the municipal transport. The transfer of taxes to municipalities has secured a sufficient volume of money to compensate for the existing special-purpose subsidies from the state budget. For the purposes of Convergence Programme, subsidies are expected to reach a level corresponding with the relevant transfer of tax revenues.

Despite macroeconomic improvement with respect to registered unemployment, the expenditures for active labour market policy are dynamically increasing. The respective expenditures should grow 0.2 percentage point by 2007 while this growth will be mainly based on programmes financed from the European Social Fund and on the co-financing from the state budget. The budget for 2005-2007 proposes to stabilise the expenditures for national programmes and co-financing at the level of 0.2% GDP.

In October 2004, a new law was approved to make major changes in the functioning of the health sector. The expenditures of health insurance companies will depend on the implementation of new laws which, along with changes on the expenditure side, also increased the inflow of resources to the system. Despite changes in the scope of free-of-charge and solidarity-based insurance package, the expenditures of the health insurance companies were raised to 4.9% GDP in the outlook for 2005 – 2007.

The changes (effective since the beginning of 2004) in the sickness insurance system are already producing expected results. The sickness benefits paid by employers during the first 10 days of sick leave reduced the general government expenditures by 0.3 percentage point. With this measure the system became less misused, which also resulted in the lower overall sickness rate in the economy.

As for the pension insurance system, the expenditures are expected to remain at a stable level of 7.5% GDP with a slight drop in 2007 to 7.4% GDP. Effective as of 1 January 2004, the legislation introduced several changes that affect the decisions of the citizens to choose the date of their retirement and the method of receiving pension benefits. Throughout 2004 the citizens were mainly taking the opportunity of retiring earlier and being able to receive pension benefit while still working. The legislation also lays down the indexation method for pensions which will increase by more than 8% in 2005. Above mentioned figures include also pension expenditures of armed forces (0.3% of GDP).

Social assistance and support are showing a slight nominal increase, albeit it is based on the reduced number of beneficiaries receiving benefits. Following the social system reform in 2004, the provision of social benefits is targeted better, which will result in savings worth some 0.6% of GDP on the general government expenditure side by 2007.

Between 2005–2007 the Ministry of Finance expects better conditions for issuing government securities, which account for the largest portion of interest expense drop by 0.3 percentage point. The activities of the Debt and Liquidity Management Agency, tasked to actively handle the state debt, are also prosucing positive results.

Capital expenditures

The positive trend in the increase of capital expenditures has been confirmed when the Government of the Slovak Republic approved the public administration budget for 2005 – 2007. The increase in capital expenditures is substantially driven by funds from the EU budget, 50 percent of which will be likely used for capital expenditures. The total amount of capital expenditures until 2007 will be kept at some 4.0% of GDP, representing an increase in expenditures by 0.8 percentage point compared to 2003.

Capital expenditures will mostly go into new motorways and expressways in order to speed up motorway construction. Within the framework of capital transfers, it is expected that funds from the ISPA and Cohesion Fund will be channelled into constructing and upgrading railway corridors. Another portion of transfers will be allocated for agriculture. In the environment sector, public investment is expected to increase by 0.3 percentage point compared to 2003.

General government revenues and expenditures in 2003-2007 (% of GDP, ESA 95, consolidated)

	2003E	2004B	2004E	2005B	2006B	2007B
TOTAL REVENUES	**36.3**	**36.2**	**35.3**	**37.1**	**36.9**	**36.9**
Tax revenues	**18.2**	**17.9**	**17.6**	**17.4**	**17.3**	**17.3**
Personal income tax	3.3	2.1	2.4	2.4	2.4	2.4
- dependent activity	3.0	1.8	2.2	2.1	2.1	2.2
- business activity	0.3	0.3	0.3	0.2	0.2	0.3
Corporate income tax	2.8	1.8	2.3	2.1	2.2	2.3
Withholding income tax	0.8	0.9	0.4	0.5	0.4	0.4
Property tax	0.5	0.4	0.5	0.3	0.3	0.3
Value-added tax	6.7	8.8	8.0	8.4	8.4	8.4
Excise taxes	3.1	3.3	3.3	3.3	3.2	3.1
Road tax	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on international trade and transactions	0.3	0.1	0.1	0.1	0.0	0.0
Local taxes (paid into municipalities)	0.3	0.3	0.3	0.2	0.2	0.2
Social security contributions	**13.9**	**13.1**	**12.5**	**13.5**	**13.5**	**13.4**
Social Insurance Agency	8.3	8.3	7.8	8.4	8.4	8.3
Health Insurance Companies	4.8	4.8	4.7	5.1	5.1	5.0
National Labour Office	0.9	0.0	0.0	0.0	0.0	0.0
Non-tax revenues	**4.2**	**3.8**	**4.0**	**4.0**	**3.6**	**3.7**
of which interest	0.7	0.5	0.4	0.4	0.3	0.3
Grants and transfers	**0.0**	**1.4**	**1.2**	**2.2**	**2.5**	**2.5**
of which from EU	0.0	1.4	1.2	2.2	2.5	2.5
TOTAL EXPENDITURES	**40.0**	**40.2**	**39.1**	**40.4**	**39.8**	**38.8**
Current expenditures	**36.9**	**36.4**	**35.4**	**36.4**	**35.9**	**34.9**
Gross wages	**7.4**	**7.2**	**7.0**	**7.0**	**6.9**	**6.8**
- Wages	5.5	5.4	5.3	5.3	5.2	5.1
- Employer social security contributions	1.9	1.8	1.8	1.8	1.7	1.7
Goods and services	**5.2**	**5.2**	**5.3**	**5.4**	**5.4**	**5.2**
- EU sources and co-financing from state budget	0.0	0.0	0.0	0.2	0.2	0.3
- Other	5.2	5.1	5.2	5.2	5.2	4.9
Subsidies and transfers	**21.8**	**21.6**	**20.8**	**21.7**	**21.2**	**20.6**
- Subsidies to agriculture	0.7	1.0	1.0	1.0	1.0	0.9
- Subsidies to transport	0.7	0.7	0.7	0.7	0.7	0.6
- Active Labour Market Policy	0.2	0.3	0.3	0.3	0.3	0.4
- Health insurance companies	4.9	4.7	4.5	4.9	4.9	4.9
- Sickness benefits	0.7	0.4	0.4	0.4	0.4	0.4
- Old age and disability pension benefits	7.6	7.5	7.5	7.5	7.5	7.4
- Unemployment benefits	0.3	0.2	0.2	0.2	0.2	0.2
- State support and social assistance benefits	2.7	2.5	2.4	2.3	2.2	2.1
- Soc.security contrib. on behalf of certain groups	2.2	1.8	1.7	1.9	1.9	1.8
- Levies to EU budget	0.0	0.7	0.6	0.9	0.9	0.9
- Other subsidies and transfers	1.7	1.8	1.5	1.5	1.3	1.1
Interest payments	**2.6**	**2.5**	**2.3**	**2.4**	**2.3**	**2.3**
Capital expenditures	**3.1**	**3.8**	**3.8**	**4.0**	**4.0**	**3.9**
Capital assets	2.5	2.6	2.6	2.6	2.5	2.3
Capital transfers	0.6	1.2	1.2	1.4	1.5	1.6
NET BORROWING (-)/LENDING (+)	**-3.7**	**-4.0**	**-3.8**	**-3.4**	**-2.9**	**-1.9**
Pay-as-you-go pillar revenues shortfall	0.0	0.0	0.0	-0.4	-1.0	-1.1
NET BORROWING (-)/LENDING (+) including PAYG shortfall	**-3.7**	**-4.0**	**-3.8**	**-3.8**	**-3.9**	**-3.0**

Source: Ministry of Finance

III.4 Cyclically Adjusted Balance

The cyclically adjusted general government balance was estimated on the basis of the methodology presented in the previous Convergence Programme. A relatively small cyclical portion of the budget compared to the total amount of general government deficit is based on relatively small output gap. Public budgets are hence facing structural problems in long-term. The ongoing general government consolidation will make it possible to reduce the cyclically adjusted primary balance to zero, when not including pension reform costs, in 2007.

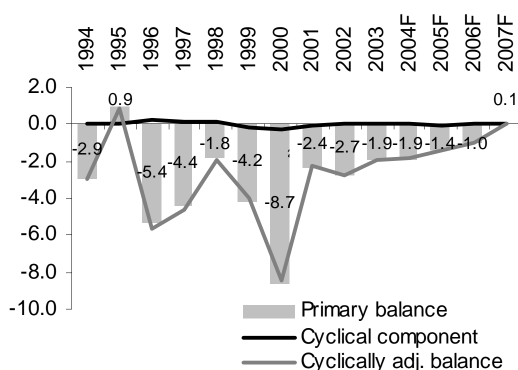
Cyclical developments (% of GDP)

	ESA code	2003	2004F	2005F	2006F	2007F
1. GDP growth, constant prices	B1g	4.2	5.0	4.5	5.1	5.4
2. Net borrowing (-)/lending (+)	B9	-3.7	-3.8	-3.4	-2.9	-1.9
3. Net interest payments		-1.8	-1.9	-2.0	-1.9	-2.0
4. Potential GDP growth		4.3	5.1	4.6	4.8	5.1
5. Output gap		0.0	-0.1	-0.2	0.1	0.3
6. Cyclical budgetary component		0.0	0.0	0.0	0.0	0.1
7. Cyclically adjusted balance (2 - 6)		-3.7	-3.8	-3.4	-2.9	-2.0
8. Cyclically adjusted primary balance (7-3)		-1.9	–1.9	-1.4	-1.0	0.0

Source: Ministry of Finance

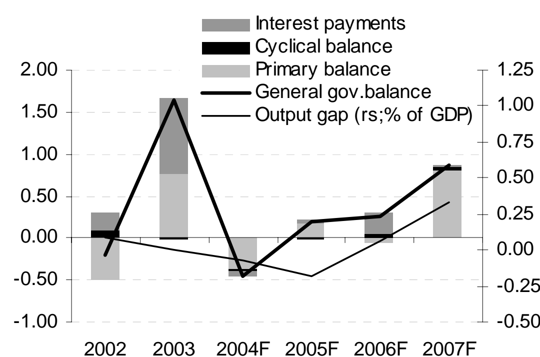
The following chart shows the individual general government deficits from a medium-term perspective. The primary balance and structural balance show a declining trend and the general government reform is producing positive results. In the past, the deficits assessed according to ESA 95 methodology have been overshadowed by one-off effects such as privatisation and restructuring of banks, which decreased their analytical value. The second chart shows the crucial contribution made by the primary balance to budget consolidation, one that should be conducive to the future reduction of public debt as a share of GDP. The changes in general government deficit and output gap will follow the same trend in the period ahead, so the consolidation objectives will not run counter to government's stabilisation objectives.

Cyclically adjusted balance of general government finances (% of GDP)



Source: Statistical Office, Ministry of Finance

Annual changes of budgetary position of general government finances and contrib. of primary, cyclical balance and interest to deficit (p.p.)



Source: Statistical Office, Ministry of Finance

III.5 Fiscal Impulse

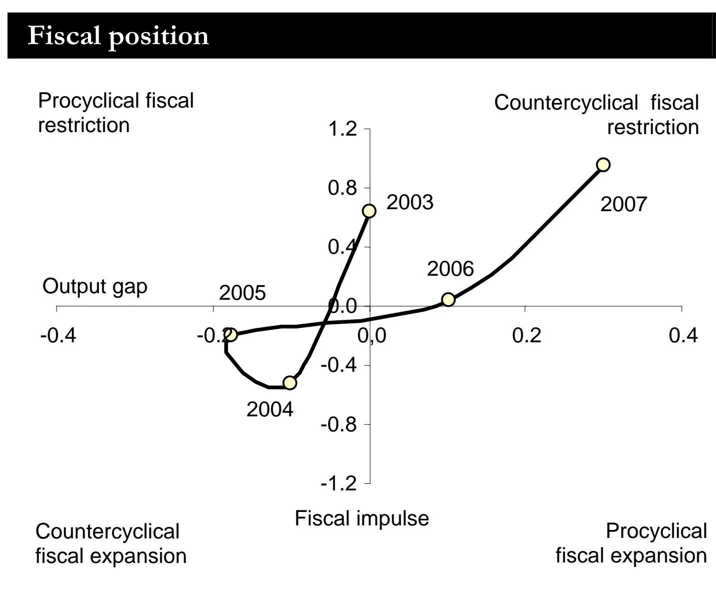
The consolidation of general government finance is the principal medium-term goal of the government. In the year 2003, with respect to the necessity of adopting structural reforms,

this objective took precedence over the stabilization function of public budgets, nonetheless, in the long run this objective is an essential condition of the latter. So far, the path opted by the government seems to have been the right choice, in the light of the fact that a substantial reduction of budget deficits is accompanied by an accelerated economic growth. This is due to the fact that consolidation is viewed as a credible policy aimed at the long-term macroeconomic balance. In this way it affects the supply side of the economy, which more than offsets a diminished contribution to the aggregate demand.

The fiscal impulse is a simple analytical concept, which measures the contribution of public budgets to the change in aggregate demand on a year-on-year basis. It indicates whether the government pursues an expansive or a restrictive fiscal policy. In conjunction with the output gap it serves to characterise the fiscal policy as to whether it has a stabilising effect on the economy or rather acts procyclical.

The fiscal impulse is usually defined as the change in the cyclically adjusted primary balance on a year-on-year basis. In the case of Slovakia, yet still in line with the concept, the balance was adjusted for two factors which have no impact on the aggregate demand. First, the balance is net of the costs associated with launching the second pillar of the pension system. These costs do not affect the overall amount of contributions paid by households and on the other hand the expenditure on pensions does not change either. However, in the general government balance they pose as revenue shortfall with a negative impact on the deficit. The second factor are the relations with the European Union, as contributions paid to the EC budget do not increase domestic demand and at the same time revenues from the EC budget do not reduce the disposable income of undertakings and households.

Fiscal position



Source: Ministry of Finance

The fiscal impulse indicates that in this year the fiscal policy is an expansive one, as well as in the upcoming year 2005, in 2006 it will be almost neutral and in the year 2007 it will have a restrictive character. The following figure shows that the fiscal policy in the 2004 to 2007 timeframe will have a stabilising effect as it will act counter the economic cycle. During this time period the government objectives aimed at the consolidation and stabilisation are harmonised.

Fiscal impulse (% of GDP)					
	2003	2004F	2005F	2006F	2007F
1. Net borrowing (-)/lending (+) – with second pillar costs	-3.7	-3.8	-3.8	-3.9	-3.0
2. Net interest payments	-1.8	-1.9	-2.0	-1.9	-2.0
3. Cyclical budgetary component	0.0	0.0	0.0	0.0	0.1
4. Cyclically adjusted primary balance (1-2-3)	-1.9	-1.9	-1.8	-2.0	-1.1
5. Impact of the relations with the EU	0.0	0.6	1.3	1.6	1.7
6. Launching 2nd pillar of pension reform	0.0	0.0	0.4	1.0	1.1
7. Cyclically adjusted primary balance (4-5+6)	-1.9	-2.4	-2.6	-2.6	-1.6
8. Fiscal impulse (+ restriction, - expansion)	0.6	-0.5	-0.2	0.1	0.9

Source: Ministry of Finance

III.6. Public Debt and Risks

Gross public debt of the Slovak Republic in the 2003 to 2007 timeframe will stabilise and towards the end of 2007 it will reach the level of 45.5 % of GDP, which is far below the maximum level of public debt permitted by the Maastricht criteria. Favourable debt trends are the result of a combination of sound economic growth and a policy aimed at reducing the deficit of general government finance. Despite an accelerating economic growth, the macroeconomic stabilisation continues, the rating of the Slovak Republic is improving and the risk margin is decreasing, which is to a certain extent transformed into a decrease of the implicit debt interest rate. The decision to use privatisation proceeds primarily to lower public debt is another factor positively affecting debt consolidation.

A nominal decrease of high-risk state guarantees plays a major role in debt stabilisation. The decrease is caused by a policy oriented on not providing any more high-risk state guarantees, which has a positive impact on both the sustainability and the transparency of general government finance.

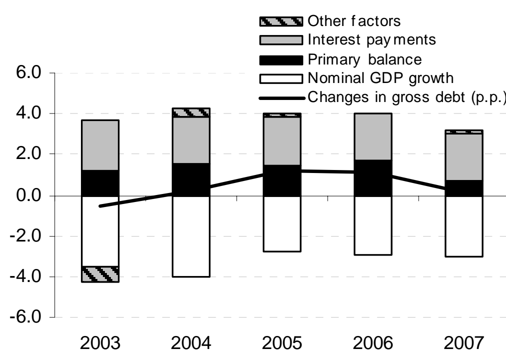
Of all general government finance items, state budget deficit and loans granted to municipalities will be the only ones contributing to public debt growth. Other sectors of public administration in the 2004 to 2007 timeframe will be characterized by balanced or surplus budgets on a cash basis. The pension reform and the establishment of the fully-funded pillar will cause a partial transformation of the implicit debt of the previous pay-as-you-go pension system into explicit debt, thus contributing to the growth of the net debt. The GDP debt growth in 2004 is caused primarily by the difference between the accrual and cash balance of general government finance. The cash balance has deteriorated due to the shortfall of VAT and excise duties, which is related to the EU accession.

Public debt indicators					
	2003	2004F	2005F	2006F	2007F
Net debt (SKK million)	330,450	396,346	427,871	478,833	542,249
Net debt (% of GDP)	27.6	30.0	30.4	31.8	33.7
Gross debt (SKK million)	511,770	567,365	622,446	681,485	732,568
of which: state guarantees	63,089	42,251	30,808	23,262	13,887
Gross debt (% of GDP)	42.8	43.0	44.2	45.3	45.5
Changes in gross debt (p.p.)	-0.6	0.2	1.2	1.1	0.1
nominal GDP growth	-3.6	-4.0	-2.7	-2.9	-3.0
primary balance	1.2	1.5	1.4	1.7	0.7
interest payments	2.5	2.3	2.4	2.3	2.3
other factors	-0.7	0.4	0.1	0.0	0.1
p.m. implicit interest rate (%)	6.4	5.9	5.8	5.5	5.5

Source: Ministry of Finance

In the 2005 to 2007 timeframe the overall impact of other factors will be minimal, nevertheless significant changes will occur within this category. On one hand, the state budget deficit will be greater than the general government finance deficit due to the fact that some other sectors will achieve a surplus. On the other hand, privatisation proceeds will be primarily used for debt reduction.

Contribution to change of gross public debt (p.p.)



Source: Ministry of Finance

With respect to the ability of the state to pay for its obligations net public debt is of considerable importance, whereby in the year 2007 it will reach 33.7 % of the GDP, which is 11.8 percentage points lower than gross public debt. Net debt is defined as gross debt less cash on the accounts of the respective public administration entities, receivables vis-à-vis the EU and receivables of the State Housing Fund, which provides low-interest loans to low-income households and municipalities, in order to promote housing development. This is however a conservative definition, which only considers high-grade and high-liquidity financial assets.

The future evolution of debt is associated with the following risks and opportunities:

- Litigations – in particular, this applies to the government's dispute with ČSOB and to the bills of exchange issued by Slovenský plynárensky priemysel.
- Debt relief in the health sector – the reform comprises the elimination of old debts and measures aimed at preventing the occurrence of new ones. The sector's overdue liabilities vis-à-vis the private sector are estimated at 1% of GDP. The repayment of old debts could be completed in the year 2004.
- Privatisation proceeds above and beyond the level of the budgeted ones – the government pursues a policy of using privatisation proceeds to reduce debt.

Sensitivity analysis

According to forecasts of the Ministry of Finance, the interest expenditures attributable to public debt will be positively impacted by a stable macroeconomic environment.

The table that follows compares the interest expense of public administration costs under the base and risk scenarios envisaging negative interest rate and exchange rate developments. It should be pointed out that even the base scenario is based on conservative assumptions. The risk scenario was specified in the same way as in the previous Convergence Programme. The risk scenario was defined as one envisaging 5% depreciation of the local currency and an increase in interest rates by 1 percentage point above the base scenario level in each year of the forecast. The decline in the risk margin ranges from 1 percentage point for one-year 1Y treasury bills to 0.2 percentage point for bonds with the longest maturity. The overall general

government finance risk fluctuates slightly below 0.1 % of GDP and should be adequately covered by the conservative approach used in base scenario quantifications.

General government interest payments (% of GDP)			
	2005F	2006F	2007F
Baseline scenario	2.00	2.16	1.91
Risk scenario	2.06	2.24	1.97
difference	0.06	0.08	0.06

Source: Ministry of Finance

IV. STRUCTURAL POLICY AND ITS IMPACT ON PUBLIC FINANCES

Slovakia has recently adopted a number of laws that fundamentally revamp the philosophy of systems on the expenditure side of public finances. These indispensable structural reforms should considerably reduce public spending over the medium- to long-term horizon. This part of the document features the most important changes that have taken place since the publication of the first Convergence Programme.

IV.1 Health Care

The hitherto central regulation of funds earmarked for the health care financing and the absence of sufficient instruments ensuring the efficient use of public funds have failed to create appropriate conditions for the proper delivery of health care. The absence of a proper legal framework that would inspire economical and responsible behaviour on the part of health insurance companies and health care providers, combined with the accumulated systemic deficiencies, prompted the revamp of the system and adoption of a new legal framework which, inter alia, exempts the state from the obligation to bail out irresponsible spenders.

One of underlying assumptions of the health care reform is a premise that the universalities of a market economy can be applied, subject to precisely defined conditions, also to the health care system. This is why the reform aims at creating a *competitive environment* in the health care sector for all actors involved in the provision of health care.

The reform will have a significant impact on the system of health insurance. The new legislation distinguishes between two basic types of health insurance – *public health insurance* and *individual health insurance*. In the *public health insurance* system, which is based on the *principle of solidarity*, the reform introduces an important systemic change -- redistribution of insurance premiums -- the purpose of which is to ensure a fairer division of the total sum collected amongst health insurance companies in proportion to the number and structure of their clients. The new law makes health insurers more engaged and responsible for the recovery of arrears in the payment of insurance premiums. *Individual health insurance* is an optional scheme based on a contract between the insured and insurer that gives the former the choice of buying insurance beyond the public health insurance coverage.

The law introduces a new feature in the public health insurance scheme – contributions are assessed on an annual as opposed to monthly income basis, the purpose of which is to capture earnings for the entire calendar year. Furthermore, the reform changes the conditions for the provision of free health care. It stipulates the scope of health care financed from public funds, the so-called *basic health care benefit package*, and categorises health

services, drugs, medical aids and dietetic needs into two basic groups. While the first group will be wholly funded from the public health insurance resources, the second group carries a co-funding component (spanning from 5 to 100 %).

The new Act on Health Insurance Companies regulates the *transformation of health insurers into joint-stock companies* whereby they become the subjects of private law. The purpose of transforming health insurers into joint-stock companies is to subject them to so-called hard budgetary restrictions (transparent financial relationships, book keeping and audit) and create for them a market environment with precisely defined conditions, where they insurers compete for clients. The sound financial condition of insurance companies will be ensured through controlled expenditures, insurers' pressure on the efficacy of health providers, and the prudence of insurance business. If, as a result of inappropriate management, an insurance company becomes insolvent and the work-out process fails, the company will face bankruptcy.

The main objective of the reform is to put in place a framework that motivates private insurance companies to take up a major market share, whereas state insurance agencies should primarily act as a safety net. However, since the existing law regulates, to a significant degree, the scope in which profit may be distributed through dividends until all the claims of the insured have been satisfied, the motivation of investors in this field requires additional fine-tuning of the system.

The role of the state has fundamentally changed: the state is no longer in the inefficient position of producer and insurer and is thus able to concentrate on the priorities in this field in the shoes of policy maker, rules maker, regulator and controller. Such system parameters should put an end to the previous practice under which the state bailed out indebted operators.

The reform has also introduced significant changes in the system of health-care provision. It increases the decision-making independence and autonomy of individual health-care providers and their responsibility for the consequences of their decisions. At the same time, the controlling and supervisory functions of the state over the conduct of health-care providers have been strengthened.

The state-run health care facilities will be transformed into joint stock companies founded by the state; the state will control 51% of shares and the remaining 49% will be held by self-governing regions, universities and municipalities. The law also regulates, in a uniform manner, the way in which funds for the provision of health care may be obtained and used (e.g. health care facilities will able to acquire assets through leasing).

The supervision over health insurers on the one hand, and health care providers on the other hand, will be preformed by the new *Health Care Supervision Authority*. The authority will be a legal person whose activities will focus on continuous supervision of compliance with the standards of public health insurance, as well as the scope and quality of health care provision. The initial cost of setting up the Authority will amount to SKK 100 million. In the following years, the Authority will be funded from contributions paid by health insurance companies (0.5% of insurance premiums after redistribution).

The effect of the reform should be visible already in 2005 through increased volume of funds in the system of public health insurance. The change in the minimum and maximum limit of the income base used for the assessment of contributions payable by the economically active persons, as well as a clear specification of the rate and amount of the assessment base for the persons insured by the state, will increase the amount of funds in the system by approximately SKK 4.5 billion. This increase would not have occurred had the original law

remained in force. The following table shows the amount of public funds in the health care sector:

Public funds in the health care sector (in SKK billion)				
	2004	2005	2006	2007
A: Total resources of health insurers	**62.9**	**72.1**	**77.0**	**81.8**
Economically active population	44.4	50.0	53.2	56.5
State	18.1	21.1	22.9	24.3
Other	0.4	0.9	0.9	1.0
Loan instalments (to SFA and Veriteľ, a.s.)	-0.2	-0.5	–2.0	-0.0
B: Available resources of health insurers	**62.7**	**71.6**	**75.0**	**81.8**
C: Ministry of Health (less insurance premiums paid by state)	**5.1***	**3.6***	**2.8**	**2.7**
D: Other funds in the budget line	**0.5**	**0.5**	**0.5**	**0.5**
Available public funds in the health care sector	**68.3**	**75.7**	**78.3**	**85.0**
Year-on-year change (%)	***7.2***	***10.8***	***3.4***	***8.6***

Source: Ministry of Finance

* including capital expenditures for self-governing regions and municipalities

This rise is mainly attributable to the increased amount of insurance premiums paid by the state (up SKK 2.6 billion) and the higher-than-expected income from premiums paid by the economically active persons (up SKK 1.9 billion). The new law sets forth a new rate of for the insurance premiums payable by the state at 4% of the average wage. The amount of insurance premiums collected in 2005 is expected to increase by 16.9% compared to 2004.

Funds in the health care sector (in SKK billion)				
	2004	2005	2006	2007
Available public funds in the health care sector	68.3	75.7	78.3	85.0
Direct payments and individual insurance	14.0	16.0	19.0	21.0
TOTAL	**82.3**	**91.7**	**97.3**	**106.0**
TOTAL to GDP (%)	**6.2**	**6.5**	**6.5**	**6.6**

Source: Ministry of Finance

IV.2 Fiscal Decentralisation

Fiscal decentralisation is taking place in a follow-up to the tax reform (effective as of 1 January 2004) and the transfer of competences from state administration to municipalities and self-governing regions (which took place in steps between 1 January 2002 and 1 January 2004). One of the important contributions of fiscal decentralisation for local self-governments is the fact that, apart from the devolved of competences and political power, they have acquired another important instrument – the power to decide on their own revenues.

The gist of the process lies in the transition from the provision of subsidies from the state budget to the funding of the functions performed by local self-government through tax revenues. The new system of funding, which will apply from 1 January 2005, will significantly strengthen the independence (and responsibility) of local self-governments in taking decisions on the use of public funds for the delivery of services to citizens. Compared to the hitherto unstable regime of annual allocation of the local self-governments' share in the tax revenue (the share was specified in the State Budget Act), the new system is expected to stabilise, in the long run, the flow of revenues in the coffers of self-governments and create ample conditions for financial planning for several years ahead. It introduces a solidarity-based, fair, transparent and motivating system of financial settlement based on specific and measurable criteria.

The objective of the new system of financing of local self-governments is to strengthen the tax revenues of municipalities and institute own tax resources for the self-governing regions (“SGR”). The new legislation changes the way in which the shared tax revenues are determined; moreover, the personal income tax has become the own source of tax revenues of self-governing regions and municipalities. As of 1 January 2005, the state effectively gives in almost the entire revenue from this type of tax to the benefit of local self-governments: 70.3% will become the own resources of municipalities, 23.5% the own resources of higher teritorial units and the state budget will retain only 6.2% of the revenue.

Unlike under the previous system based on the number of inhabitants, four criteria will be applied in dividing the tax revenue among municipalities. One of the criteria is the number of inhabitants with permanent residence in the municipality. The *number of inhabitants adjusted by the size coefficient* will be the criterion of the highest weight; other criteria include the share of inhabitants aged 3 to 14 and the share of the senior citizens.
In the case of self-governing regions, the main criterion for determining the share of individual SGRs in the tax revenue is *the number of inhabitants in the region aged 62 and more*. The resulting share will also be influenced by the total number of inhabitants with permanent residence in the territory of the region, number of inhabitants aged 15-18, the length of the roads of 1st and 2nd class in the ownership of the region, density of population and territorial size of the region.

Fiscal decentralisation gives municipalities free hands in setting the rates of local taxes. Local taxes will not be mandatory, which means that municipalities will not only have the power to set the tax rates, but also to introduce a tax. The law only sets the initial rates, but municipalities will have full discretion to adjust those rates and apply exemptions. From the year 2005, municipalities will have the power to impose and collect eight local taxes – *real estate tax, dog tax, tax for the use of public areas, accommodation tax, vending machines tax, gaming and toy machines, tax for drive into historical centre, and a nuclear facility*. There will be only one local charge -- for communal and minor construction waste. The adoption of the fiscal decentralisation laws puts an end to the subsidies for metropolitan public transport.

The SGR will introduce a new tax – the car tax – which will replace the currently applicable road tax. Also in this case, regional self-governments will have the discretion of introducing the car tax and setting its rate. The car tax will apply to motor vehicles used for or in connection with business purposes.

The adoption of the fiscal decentralisation laws effectively abolished the budgetary chapter of transfers from state budget to municipalities and self-governing regions; the subsidies will be transformed into the own tax resources of municipalities and self-governing regions. According the MoF estimates, the total volume of subsidies transformed into tax revenues and other resources should reach SKK 33,854.9 million in 2005. For this year, the state guarantees a neutral impact of fiscal decentralisation upon the budgets of local self-governments. Should the actual tax revenue at the local level in 2005 be lower than the guaranteed amount, the state will provide compensation; any revenues in excess of the projected level will be retained by local self-governments.

In the years 2006 and 2007, the reform is expected to yield higher revenues to local self-governments than the revenues they would have in the absence of the reform. The Ministry of Finances estimates the tax revenues to develop as follows:

Total revenues of local self-governments after fiscal decentralisation (SKK bn)			
	2005B	2006B	2007B
Income tax – natural persons	33,184	35,302	38,784
of which:			
- municipalities (70.3%)	23,328	24,817	27,265
- SGR (23.5%)	7,799	8,296	9,114
Car tax			
- SGR (100%)	2,500	2,550	2,600
Impact of fiscal decentralisation upon state budget in 2005-2007			
Fiscal decentralisation	33,627	35,663	38,979
Budgetary chapter of transfers to munic. and self-governing regions	33,627	34,771	35,673
Difference	0,0	0,892	3,306

Source: Ministry of Finance

The competences, which municipalities and self-governing regions will perform on behalf of the central administration, will continue to be financed from the state budget through the respective budgetary lines.

The new law introduces the system of multi-annual budgeting (for three-year periods). This will create a more efficient link between the budgetary period and the term of election to local and regional councils and, in particular, with the long-term commitments of municipalities and SGR. The budget of the revenues and expenditures for the two years that follow the year for which the budget is compiled is not obligatory and may be adjusted in the next budget year.

The fiscal decentralisation law also creates barriers to unjustified amassments of debts in local self-governments. The conditions for the acceptance of loans have become more stringent. The maximum debt of a local self-government may not exceed 60% of its annual current revenues; the municipality or SGR may spend a maximum of 25% of current revenues on debt service.

The new system of local self-government financing is expected to create ample conditions for better utilisation of resources and increased responsibility of the elected bodies of local governments. It also initiates a higher degree of citizens' participation, improves the flow of information on the use of public funds, and provides for a more selective approach to addressing specific needs of the citizens in individual regions.

IV.3. Act on Budgetary Rules

The reform of public administration and the changes connected with the accession of Slovakia to the European Union have been the main driving forces behind the creation of a new comprehensive legislative framework for the budgetary process in the sector of public administration. It was also one of the important measures indicated in the Programme Declaration of the Government.

The new legislation respects the methodology of the European System of Accounts (ESA 95) and provides a single and universally valid definition of the public administration sector, defines the entities of the sector, specifies public funds and, thereby, ensures consistent application of ESA 95 in the Slovak Republic.

The new Act on Budgetary Rules, which the Slovak parliament enacted in September 2004, covers the budget of public administration in its entirety and places specific emphasis on the

state budget. The result-oriented budgeting has become an integral part of the budgetary process (budget design and implementation). The Act introduces multi-annual budgeting for the entire public administration. The revenues and expenses of the public administration budget (state budget and budgets of other entities making up the system of public administration) are budgeted for three years. The budgets for the second and third year of the budgetary period (i.e. the years that follow the current budget year for which the Act on State Budget is submitted for approval) are indicative and may be adjusted in the following budgetary year.

The Act also introduces new rules for the spending of budgeted funds in the state budget. The Act also lays down conditions for latter disbursement of funds for capital expenditures, for European Union funds, and for the co-financing provided from the state budget. New rules also apply to the provision and classification of borrowed funds from. Unless spent in the year for which they are budgeted, the funds may be drawn also in the next year and become the expenditures of the budget for the year in which there are used.

There is new regime of sanctions for the breach of financial discipline and the provisions of the law are uniform for all entities of public administration. The performance of financial control and state supervision continues to be regulated by the Act on Financial Control.

V. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

Long-term sustainability of public finances is a crucial goal for the Slovak Republic. For the purposes of the Convergence Programme, the long-term sustainability was defined as the ability to maintain the general government deficit below 3% of GDP and net indebtedness below 60% of GDP prior to and after the culmination of demographic problems around 2055. It could be achieved via further budgetary improvement (close to balance in 2010) and additional structural reforms (further increase of the pension age to 65 and change in the indexation mechanism for pensions). For obvious reasons, no update of long-term projections has been carried out since May. A novelty is the matching of medium-term figures with the current general government budget estimate for 2005-2007. Therefore, we are providing an abridged version of the analysis from the Convergence Programme of May 2004.

V.1. Demography

For the purposes of the Convergence Programme, the Ministry of Finance of the Slovak Republic prepared its own population simulation, based on the facts found during the population census in 2001 and on expectations by the Demographic Research Centre. For comparison, the table also includes the assumptions used by the World Bank when projecting demographic developments.

Demographic assumptions									
	Slovak Republic							EU average	
Baseline scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**	**2000**	**2050**
Population ('000)	**5,381**	**5,404**	**5,447**	**5,405**	**5,237**	**5,031**	**4,379**		
aged 0-14	941	810	812	751	662	664	594		
aged 15-64	3,817	3,919	3,735	3,518	3,308	2,904	2,506		
aged 65 +	622	674	900	1,136	1,267	1,463	1,279		
Life expectancy (M)	70.2	71.3	73.3	74.9	76.0	77.1	81.0	75.0	80.0
Life expectancy (F)	78.0	79.0	80.8	82.2	83.0	84.0	87.7	81.3	85.5
Fertility rate	1.17	1.28	1.46	1.58	1.64	1.70	1.70	1.50	1.70
Migration balance ('000)	1.4	2.4	4.2	5.9	7.7	9.5	15.0		
Net migration (% pop.)	0.03	0.05	0.08	0.11	0.15	0.19	0.34		
World Bank assumptions									
Fertility rate	1.40	1.40	1.70	2.00	2.10	2.10	2.10		
Life expectancy	73.3	75.1	76.6	78.0	79.5	81.1	84.3		
Low scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**	**2070**	**2080**
Population ('000)	5,381	5,402	5,399	5,270	5,005	4,657	4,261	3,842	3,464
Fertility rate	1.17	1.22	1.34	1.42	1.46	1.50	1.50	1.50	1.50
Migration balance ('000)	1.4	0.7	1.6	2.3	2.8	3.4	3.9	4.5	5.0
High scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**	**2070**	**2080**
Population ('000)	5,381	5,407	5,507	5,570	5,531	5,470	5,396	5,328	5,337
Fertility rate	1.17	1.38	1.66	1.82	1.86	1.90	1.90	1.90	1.90
Migration balance ('000)	1.4	4.3	8.1	11.2	13.7	16.1	18.6	21.0	23.5

Source: Ministry of Finance

Currently, the Slovak Republic is among EU member states with the lowest fertility rate (Italy, Spain, Luxembourg). Despite that we expect the *fertility rate* to grow in the years to come, reaching the level of the former EU 15 in 2050. By that same year, the life expectancy will rise by more than 7 years with men and by 6 years with women.

At such parameters, it is expected that, in demographic terms, the most critical population structure will emerge at around 2060, when the ratio of people older than 65 to economically active population (15-64) will reach almost 58%. This relation is reflected by the "old age dependency ratio", indicating that the aging problem in Slovakia is not as urgent as in the European Union. Despite that this development will come about here quickly and the growth of the indicator will stop as late as in 2060, when its value hits three times the 2002 level.

Demography – indicators									
	Slovak Republic							EU average	
	2002	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**	**2000**	**2050**
Old Age Dependency ratio (inv.)	6.14	5.81	4.15	3.10	2.61	1.99	1.96	4.17	2.04
2002 index	*1.00*	*0.95*	*0.68*	*0.50*	*0.43*	*0.32*	*0.32*	*1.00*	*0.49*

Source: Ministry of Finance

V.2. Results

The following table summarises the results of the projection:

Expected development of the public finances through 2080 – baseline scenario (% of GDP)

	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050	2060	2070	2080
Tax revenues	17.6	17.4	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3
Tax bonus	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Social security contributions	12.5	13.5	13.5	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4
2nd pillar contributions	0.0	0.4	1.0	1.1	1.2	1.3	1.3	1.5	1.7	1.9	2.0	2.0	2.0	2.0
Other revenues	5.2	6.2	6.1	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
Total revenues	**35.3**	**37.1**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**	**36.9**
Current expenditures	**35.4**	**36.4**	**35.9**	**34.9**	**34.3**	**33.3**	**32.4**	**30.6**	**31.3**	**32.1**	**33.4**	**33.8**	**32.7**	**31.9**
Pension system	7.2	7.2	7.2	7.1	6.9	6.8	6.6	5.8	6.6	7.0	7.4	6.8	5.5	4.8
Health care	4.5	4.9	4.9	4.9	5.0	5.0	5.1	5.5	6.0	6.4	6.6	6.6	6.5	6.5
Unemployment benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0
School system	3.7	3.7	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Child allowances	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.5	0.4	0.4
Other expenditures	19.1	19.9	19.5	18.8	18.2	17.4	16.6	15.3	14.8	14.9	15.5	16.5	16.9	16.8
wages	7.0	7.0	6.9	6.8	6.6	6.5	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
goods and services	5.3	5.4	5.4	5.2	4.9	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
interest	2.3	2.4	2.3	2.3	2.3	2.2	2.1	0.8	0.3	0.4	1.0	1.9	2.4	2.2
other	4.6	5.1	4.9	4.5	4.3	4.0	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Capital expenditures	**3.8**	**4.0**	**4.0**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**
Total expenditures	**39.1**	**40.4**	**39.8**	**38.8**	**38.2**	**37.2**	**36.3**	**34.5**	**35.2**	**36.1**	**37.3**	**37.7**	**36.6**	**35.8**
DEFICIT	**-3.8**	**-3.4**	**-2.9**	**-1.9**	**-1.3**	**-0.3**	**0.6**							
DEFICIT (including PAYG pillar shortfall)	-3.8	-3.8	-3.9	-3.0	-2.5	-1.6	-0.7	0.9	0.0	-1.0	-2.4	-2.8	-1.8	-0.9
Primary balance	-1.5	-1.4	-1.7	-0.7	-0.2	0.7	1.4	1.7	0.2	-0.6	-1.4	-0.9	0.6	1.3
GROSS DEBT	**43.0**	**44.2**	**45.3**	**45.5**	**43.7**	**40.7**	**37.0**	**13.5**	**4.8**	**7.8**	**20.8**	**38.0**	**44.6**	**41.6**
NET DEBT	**30.0**	**30.4**	**31.8**	**33.7**	**33.1**	**31.4**	**29.0**	**5.5**	**-3.2**	**-0.3**	**12.7**	**30.0**	**36.6**	**33.6**

Source: Ministry of Finance

Remarks:
1) beyond 2007 GDP growth is equal to potential output growth
2) wages indexed by headline inflation + 2% (2008 - 2010)
3) goods and services indexed by 2% a year (2008 - 2010)
4) other expenditures indexed by 2% a year (2008 – 2010)
5) gross debt is calculated as deficit (ESA95) + PAYG pillar shortfall (since 2011)
6) net debt is calculated as gross debt + net change of the cash deposit on accounts (debt increases due to the decrease of deposit in NBS)
7) deficit due to the introduction of the 2nd pillar is financed by privatisation revenues until 2010 (deposit in NBS)
8) average interest rate for the calculation of interest cost (debt service) was set at 5.5%
9) primary balance calculated only with interest paid by general government
10) pension system expenditures do not include pension benefits of armed forces

As we can see from the results, the further consolidation of public finances in the 2008-2010 period will underpin the long-term sustainability of public finances (as a result of the adjustment of the expenditures shown below the table). Without any further changes, Slovakia's public finances will be ready to resist the pressures resulting from the aging of our population. The key element to achieving this goal is to bring public finances in balance by the end of this or at the beginning of the next decade, which is a fundamental prerequisite for effective debt reduction.

VI. COMPARISON WITH MAY 2004 CONVERGENCE PROGRAMME

The current update confirms the future development trends in macroeconomic and fiscal parameters that were presented in Slovakia's first Convergence Programme. In the light of the actual developments in the national economy and external environment in the recent past, it was necessary to make several corrections, but in most cases they were either immaterial or had a positive impact on Slovakia's further real and nominal convergence process. Several corrections or, conversely, unchanged original estimates, reflect the conservative nature of the submitted macroeconomic projections. These forecasts will remain conservative also in the future in order to avoid situations where the meeting of the fiscal goals is put at risk due to overly optimistic estimates of macroeconomic development.

The update for 2004 brings higher estimates of economic growth mainly due to favourable developments in wages and domestic demand. The years following 2004 reflect the arrival of more investments, namely in the automotive industry. The growth of the Slovak economy will remain at relatively high, yet sustainable, levels. A margin already built in the estimate of price development enabled us to keep the headline inflation rate projection unchanged. It seems that stronger economic growth could slightly support the meeting of fiscal objectives, having a positive impact on the reduction of the general government deficit and, with some delay, also on the debt-to-GDP ratio.

Divergence from previous update (Convergence programme, May 2004)

	ESA code	2003E	2004F	2005F	2006F	2007F
GDP growth (%)						
Previous update	B1g	4.2	4.1	4.3	5.0	4.7
Latest update	B1g	4.2	5.0	4.5	5.1	5.4
Difference		0.0	0.9	0.2	0.1	0.7
Actual budget balance (% of GDP)						
Previous update	B9	-3.6	-4.0	-3.4	-3.0	-2.0
Latest update	B9	-3.7	-3.8	-3.4	-2.9	-1.9
Difference		-0.1	0.2	0.0	0.1	0.1
General government gross debt (% of GDP)						
Previous update		42.8	45.1	46.4	46.1	45.5
Latest update		42.8	43.0	44.2	45.3	45.5
Difference		0.0	-2.1	-2.2	-0.8	0.0

Source: Ministry of Finance

ANNEXES

Annex 1 - Indicative forecast until 2010

Forecast until 2010							
	Unit	2003	2004F	2005F	2006F	2007F	Average 2008F–2010F
GDP, constant prices 1995	%	4.2	5.0	4.5	5.1	5.4	4.3
Final household consumption	%	-0.4	3.0	4.1	3.9	4.0	3.5
General government final consumption	%	2.9	0.9	1.5	2.2	1.5	1.1
Gross fixed capital formation	%	-1.2	3.3	7.5	6.0	3.3	4.3
Exports of goods and services	%	22.6	12.4	10.5	13.9	12.8	9.5
Imports of goods and services	%	13.8	11.8	11.1	13.0	9.6	9.2
Average annual inflation rate	%	8.5	7.8	3.3	2.8	2.5	3.5
Current Account Balance (BoP)	% of GDP	-0.9	-2.2	-2.8	-2.1	0.3	-0.5
Average number of workers (as per Labour Force Survey)	%	1.8	0.0	0.6	0.6	0.9	0.7
Average unemployment rate (as per Labour Force Survey)	%	17.4	18.5	17.9	17.3	16.5	13.5
Average real monthly wage of a worker	%	-2.0	1.6	3.1	2.9	3.0	2.8
Average SKK/EUR exchange rate	Sk	41.5	40.0	39.4	39.0	39.0	39.0
General Government Revenues (ESA 95) *	% of GDP	36.3	35.3	37.1	36.9	36.9	36.9
General Government Expenditures (ESA 95)	% of GDP	40.0	39.1	40.4	39.8	38.8	37.2
General Government Balance (ESA 95) *	% of GDP	-3.7	-3.8	-3.4	-2.9	-1.9	-0.3

** disregarding the impact of the 2nd pillar*
Source: Ministry of Finance

Annex 2 - Committee on Macroeconomic Forecasts

With the aim to bring more transparency and objectiveness to macroeconomic forecasts, the Ministry of Finance addressed the members of the Committee on Macroeconomic Forecasts again. The update of forecasts by particular member organisations and the assessment of MoF forecast took place in the Committee in July 2004 so that the obtained results could be considered in the process of updating the multi-annual budget proposal.

The MoF's medium-term forecast, which is the basis of assumptions for the 2005-2007 budget, was rated by the members of the Committee as realistic or slightly conservative:

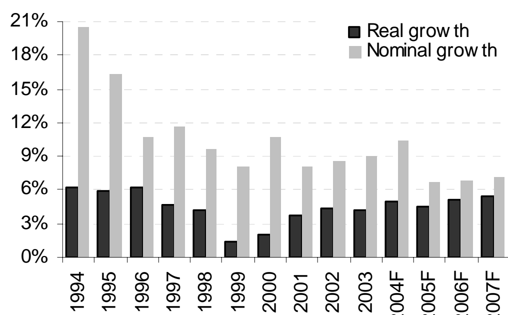
- conservative (ING Bank)
- slightly conservative (Tatra banka)
- conservative (SLSP)
- realistic (Infostat)
- realistic (VÚB)
- realistic (SAV - conservative 37%, realistic 25%, optimistic 38%)
- realistic (NBS)

Committee on Macroeconomic Forecasts (average, without the MoF)				
	Unit	2005F	2006F	2007F
GDP at current prices	mld. Sk	1,430.6	1,549.6	1,684.1
Real GDP growth	%	4.9	5.4	5.7
Final household consumption, real growth	%	4.6	4.3	4.2
Final household consumption, nominal growth	%	7.9	7.4	7.2
Average monthly wage in the whole economy (nominal growth)	%	7.5	7.1	6.7
Average employment growth as per Labour Force Survey	%	0.9	0.9	1.0
Average employment growth according to the number of unemployment claims	%	0.7	0.7	0.8
Consumer price index (average growth)	%	3.5	3.1	2.9
Producer Price Index (average growth)	%	2.5	2.3	2.2
Current Account Deficit (% of GDP)	%	-2.7	-2.0	0.3
General government final consumption (real growth)	%	2.9	3.2	1.2
Gross fixed capital formation (real growth)	%	9.3	8.0	5.8
Exports of goods and services (real growth)	%	9.6	14.0	14.9
Imports of goods and services (real growth)	%	10.7	13.6	13.1
Unemployment rate (average, Labour Force Survey)	%	16.0	15.4	14.7

Source: Committee on Macroeconomic Forecasts

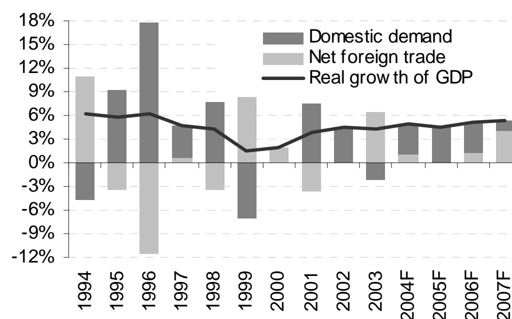
Annex 3 – Graphs

GDP growth in %



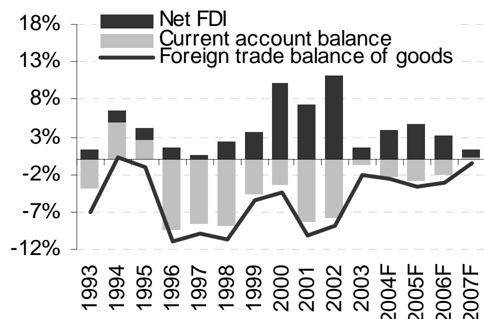
Source: Statistical Office, Ministry of Finance

Contribution to GDP growth in percentage points



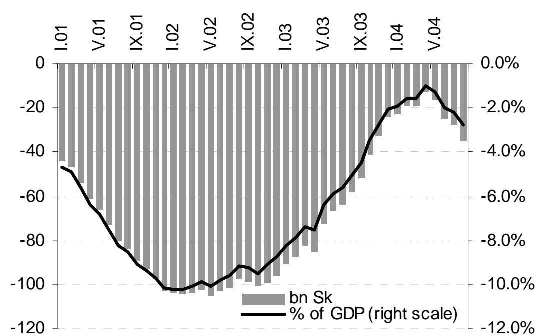
Source: Statistical Office, Ministry of Finance

Trade balance as a % of GDP



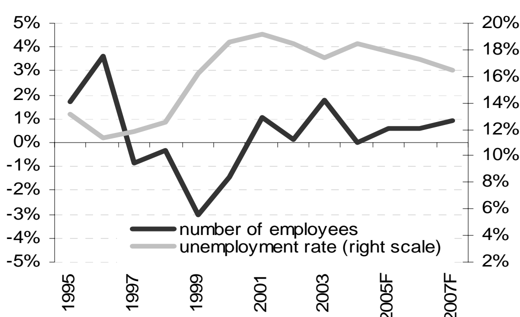
Source: Statistical Office, Ministry of Finance

Trade balance, 12-month, rolling



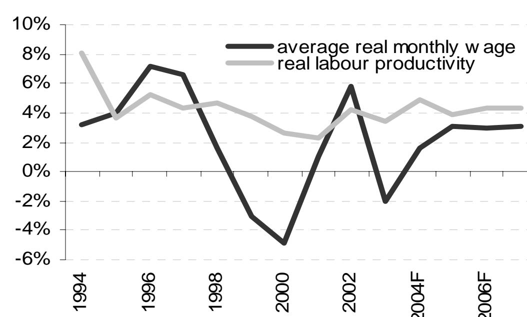
Source: Statistical Office, Ministry of Finance

Economic activity as per Labour Force Survey



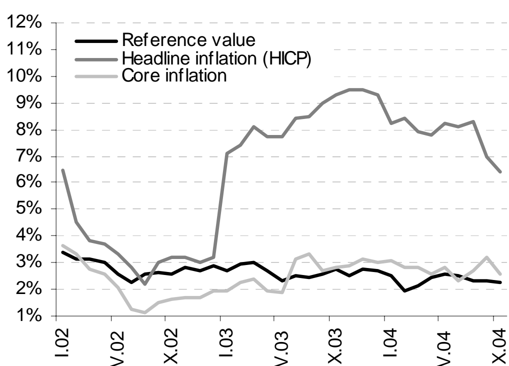
Source: Statistical Office, Ministry of Finance

Real wage and labour productivity



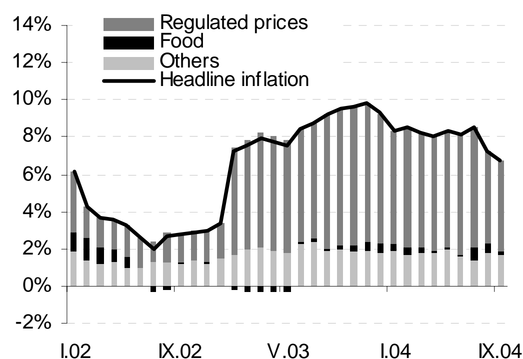
Source: Statistical Office, Ministry of Finance

Inflation



Source: Statistical Office, Ministry of Finance

Structure of total inflation, in percentage points



Source: Statistical Office, Ministry of Finance

Annex 4 – Requested tables

Table 1: Growth and associated factors (%, except as stated otherwise)

	ESA code	2003	2004F	2005F	2006F	2007F
GDP growth at constant market prices (7+8+9)	B1g	4.2	5.0	4.5	5.1	5.4
GDP level at current market prices, bn. SKK	B1g	1,195.8	1,319.9	1,407.4	1,503.8	1,611.3
GDP deflator (year-on-year growth)		4.7	5.1	2.0	1.7	1.7
CPI Change (annual average)		8.5	7.8	3.3	2.8	2.5
Employment growth*		1.8	0.0	0.6	0.6	0.9
Labour productivity growth**		3.4	5.0	3.8	4.4	4.4
Sources of growth: percentage changes in constant prices						
1. Private consumption expenditures	P3	-0.4	3.0	4.1	3.9	4.0
2. Public administration expenditures	P3	2.9	0.9	1.5	2.2	1.5
3. Gross fixed capital formation	P51	-1.2	3.3	7.5	6.0	3.3
4. Changes in inventories and net acquisition of valuables as % of GDP***	P52 + P53	-0.7	0.4	0.8	0.6	-1.1
5. Exports of goods and services	P6	22.6	12.4	10.5	13.9	12.8
6. Imports of goods and services	P7	13.8	11.8	11.1	13.0	9.6
Contribution to GDP growth						
7. Final domestic demand (1 + 2 + 3)		0.1	2.6	4.3	3.9	3.1
8. Change in inventories and net acquisition of valuables (= 4) ***	P52 + P53	-2.3	1.1	0.4	-0.2	-1.8
9. External balance of goods and services	B11	6.4	1.2	-0.1	1.3	4.1

**according to the Labour force survey*
*** GDP growth at market prices per employed person at constant prices*
**** Including statistical discrepancy*
Source: Statistical Office, Ministry of Finance

Table 2: General government budgetary developments (% of GDP)

	ESA code	2003E	2004F	2005B	2006B	2007B
Net lending (B9) by sub – sectors						
l. General government	S13	-3.7	-3.8	-3.4	-2.9	-1.9
2. Central government	S1311	-4.2	-3.4	-3.9	-3.5	-3.1
3. State government	S1312	0.0	0.0	0.0	0.0	0.0
4. Local government	S1313	-0.1	-0.1	0.0	0.0	0.0
5. Social security funds	S1314	0.5	-0.3	0.5	0.5	1.2
General government (S13)						
6. Total receipts	ESA	36.3	35.3	37.1	36.9	36.9
7. Total expenditures	ESA	40.0	39.1	40.4	39.8	38.8
8. Budget balance	B9	-3.7	-3.8	-3.4	-2.9	-1.9
9. Net interest payments		-1.8	-1.9	-2.0	-1.9	-2.0
10. Primary balance		-1.9	-1.9	-1.4	-1.0	0.1
Components of revenues						
11. Taxes	D2+D5	18.2	17.6	17.4	17.3	17.3
12. Social contributions	D61	13.9	12.5	13.5	13.5	13.4
13. Interest income	D41	0.7	0.4	0.4	0.3	0.3
14. Other		3.5	4.8	5.8	5.8	5.8
15. Total receipts	ESA	36.3	35.3	37.1	36.9	36.9
Components of expenditures						
16. Public consumption		12.6	12.3	12.4	12.3	12.0
17. Social transfers other than in kind	D62	18.4	16.8	17.2	17.1	16.8
18. Interest payments	D41	2.6	2.3	2.4	2.3	2.3
19. Subsidies	D3	1.5	1.7	1.7	1.7	1.6
20. Gross fixed capital formation	P51	2.5	2.6	2.6	2.5	2.3
21. Other		2.6	3.5	4.1	4.0	3.9
- other current subsidies and transfers		*1.9*	*1.7*	*1.8*	*1.6*	*1.4*
- capital transfers		*0.6*	*1.2*	*1.4*	*1.5*	*1.6*
- levies to EU budget		*0.0*	*0.6*	*0.9*	*0.9*	*0.9*
22. Total expenditures	ESA	40.0	39.1	40.4	39.8	38.8

Source: Ministry of Finance

Table 3: General government – debt developments (% of GDP)

	ESA code	2003E	2004F	2005F	2006F	2007F
Gross debt level		42.8	43.0	44.2	45.3	45.5
Change in gross debt		-0.6	0.2	1.2	1.1	0.1
Contributions to change in gross debt						
Primary balance		1.2	1.5	1.4	1.7	0.7
Interest payments	D41	2.5	2.3	2.4	2.3	2.3
Nominal GDP growth	B1g	-3.6	-4.0	-2.7	-2.9	-3.0
Other factors		-0.7	0.4	0.1	0.0	0.1
p.m. implicit interest rate on debt (in %)		6.4	5.9	5.8	5.5	5.5

Source: Ministry of Finance

Table 4: Cyclical developments (% of GDP, ESA 95)

	ESA code	2003	2004F	2005F	2006F	2007F
1. GDP growth, constant prices	B1g	4.2	5.0	4.5	5.1	5.4
2. Net borrowing (-)/lending (+)	B9	-3.7	-3.8	-3.4	-2.9	-1.9
3. Net interest payments		-1.8	-1.9	-2.0	-1.9	-2.0
4. Potential GDP growth		4.3	5.1	4.6	4.8	5.1
5. Output gap		0.0	-0.1	-0.2	0.1	0.3
6. Cyclical budgetary component		0.0	0.0	0.0	0.0	0.1
7. Cyclically adjusted balance (2 - 6)		-3.7	-3.8	-3.4	-2.9	-2.0
8. Cyclically adjusted primary balance (7-3)		-1.9	–1.9	-1.4	-1.0	0.0

Source: Ministry of Finance

Table 5: Divergence from previous update (% of GDP)						
	ESA code	2003	2004F	2005F	2006F	2007F
GDP growth (%)						
Previous update	B1g	4.2	4.1	4.3	5.0	4.7
Latest update	B1g	4.2	5.0	4.5	5.1	5.4
Difference		0.0	0.9	0.2	0.1	0.7
Actual budget balance						
Previous update	B9	-3.6	-4.0	-3.4	-3.0	-2.0
Latest update	B9	-3.7	-3.8	-3.4	-2.9	-1.9
Difference		-0.1	0.2	0.0	0.1	0.1
Gross debt levels						
Previous update		42.8	45.1	46.4	46.1	45.5
Latest update		42.8	43.0	44.2	45.3	45.5
Difference		0.0	-2.1	-2.2	-0.8	0.0

Source: Ministry of Finance

Table 6: Long – term sustainability of public finances (% of GDP)						
	2004F	2005F	2010F	2020F	2030F	2050F
Total expenditures	39.1	40.4	36.3	34.5	35.2	37.3
Old – age pensions	7.2	7.2	6.6	5.8	6.6	7.4
Health care (including care for the elderly)	4.5	4.9	5.1	5.5	6.0	6.6
Interest payments	2.3	2.4	2.1	0.8	0.3	1.0
Total revenues	35.3	37.1	36.9	36.9	36.9	36.9
of which: from pension contributions	12.5	13.5	13.4	13.4	13.4	13.4
Assumptions						
Labour productivity growth	5.0	4.0	3.4	3.4	2.5	2.3
Real GDP growth	5.0	4.5	4.1	3.3	2.0	1.5
Participation rate males (aged 15-64)	76.7	77.2	78.0	79.9	79.4	78.7
Participation rate females (aged 15-64)	62.9	63.4	64.1	67.8	68.2	68.1
Total participation rate (aged 15-64)	69.8	70.3	71.0	73.9	73.8	73.5
Unemployment rate (ILO definition)	18.5	17.9	13.2	10.8	8.8	4.9

Source: Ministry of Finance